Corporate Governance and Managerial Misconduct

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Chapter 1

Introduction

1.1 Introduction

Corporate governance can be described as a set of mechanisms or practices that help aligning objectives and interests between the suppliers of funds and the managers of corporations (Shleifer and Vishny, 1997). This definition stems from a principal-agent view, which addresses how to minimise conflicts between shareholders and managers. The central theme of agency theory is to control opportunistic behaviour by management, because managers may have interests that diverge from that of shareholders’ interests. Opportunistic managerial behaviour may lead to managerial misconduct.

The issue of managerial misconduct has been existing since the first emergence of a stock-based company. The Verenigde Oost-indische Compagnie (VOC), the Dutch United East India Company, which was established in 1602, pioneered the novel legal form of a firm as a limited liability company (Dutch East India Company)¹. The VOC, the first ever multinational company in the world that sold shares to the public, stretched its dominance from Japan, Southeast Asia, South Asia and South Africa. After almost two centuries since its inception, the VOC went bankrupt in 1799. Besides increased competition, the main cause of the insolvency was the conflict of interest between the shareholders and the directors. The directors refused to provide audited financial statements. Moreover, the directors were accused of managerial misconduct and corruption (Van Riebeeck and the South-East Asian Connection to the Cape, 2015; de Jongh, 2010).

Since the 1980s, numerous blatant corporate crimes have occurred around the world, such as Wells Fargo in the United States (Quartz at Work, 2017), Kobe Steel in Japan (Bloomberg, 2017), Felda Global Ventures Holdings in Malaysia (New Straits Times, 2017), and Meikarta (the Jakarta Post, 2018) and SNP Finance (the Jakarta Post, 2018) both in Indonesia. The latest fraud survey by the Association of Certified Fraud Examiners (ACFE) reported that the total fraud loss around the world was higher than $7 billion, based upon 2,690 fraud cases which included asset misappropriation, corruption, and financial fraud (ACFE, 2018). The 2017 Asia-Pacific Fraud Survey found that 63% of the respondents perceived that corrupt practices widely occurred in their country, and 35% of them believed that unethical conduct was common in order to secure business (EY, 2017).

The 2019 data reveal that Indonesia ranks relatively low on the list of least corrupt countries, i.e., 85th of 180 countries with a score of 40.2 (Transparency International, 2020), indicating that Indonesia is perceived as relatively highly corrupt. A survey conducted by Ernst & Young in 2013 reported that 79% of respondents, consisting of executives, senior managers and employees, agreed that “corrupt practices happen widely in Indonesia” (EY, 2013). The likelihood of fraud can be limited by installing measures or mechanisms aimed at preventing companies from becoming involved in unethical practices. These mechanisms focus on the monitoring of executives of companies and their decision-making.

Corporate governance may provide mechanisms that help preventing managerial misconduct. These corporate governance mechanisms are based on the underlying principles of transparency, accountability, responsibility and fairness. Two kinds of mechanisms are prescribed in the corporate governance literature, i.e., internal control mechanisms and external control mechanisms (Walsh and Seward, 1990; Denis and McConnell 2003). Internal control mechanisms are derived from the internal organisation, such as shareholders, board of directors, managerial compensation, operating procedures, and internal controls. External control mechanisms consist of

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2 The score ranges from 0 (highly corrupt) to 100 (very clean).
factors external to the company, such as laws and regulations, codes, capital markets, and competition (Cuervo, 2002; Gillan, 2006; Hanson and Song, 2006). Both mechanisms are intended to mitigate agency problems, i.e., conflicts between shareholders and management, and, or between minority shareholders and majority shareholders.

1.2 Corporate Governance in Asia

Corporate governance practices vary across countries (Arcot and Bruno, 2007). In a broader context, corporate governance practices may be influenced by foreign factors (such as globalization, market liberalization) and domestic factors (such as political, economic, and law systems) (Aguilera and Cuervo-Cazurra, 2004). There are two main types of corporate governance systems in the world, i.e., the Anglo-American (Anglo-Saxon) model and the Continental (Western) European model (Judge, 2010). The Anglo-Saxon model is characterised by more dispersed shareholders, a one-tier board structure, and more reliance on market (external) mechanisms (Cuervo, 2002; Soederberg, 2003). On the other hand, the Continental European model is more likely to feature concentrated shareholders, with a two-tier board structure, and a heavier reliance on internal control mechanisms (Cuervo, 2002; Goergen et al., 2008).

After the Asian financial crisis in 1998, the Southeast Asian countries were encouraged by international institutions such as the OECD, IMF, and World Bank to adopt features of the Anglo-American corporate governance model (Nowland, 2007). Since then, a roaring applause has been extended by commentators to the countries, because of the great improvement in corporate governance practices and the level of transparency (Nowland, 2008; Ananchotikul and Eichengreen, 2009). However, corporate governance systems of most Asian countries are still very similar to the Continental European model, in which the agency conflict is prevalent in the form of minority shareholders expropriation by controlling shareholders (Claessens et al., 1999, 2000; Mitton, 2002; Krishnamurti et al., 2005; Moskalev and Park, 2010; Yoshikawa and Rasheed, 2010). The unique landscape of Asian business has called the interest of scholars to investigate corporate governance practices in Asian countries. Some assert
that the severity of the 1997 East Asian crisis partly is caused by lack of good governance practices (Johnson et al., 2000; Haggard, 2002).

Business in East Asia, including Indonesia, is represented by at least three key characteristics. First, business is dominated by concentrated family ownership or business groups rather than dispersed shareholdings (Claessens, et al., 2000; Carney and Child, 2013). Second, business is heavily based on a relation-based model rather than a market-based one (Li, 2003). Third, business is more likely to seek and engage in political connections (Luo, 2002; Chen et al., 2011). Since emerging economies are characterised by a weak institutional framework and a lack of efficient capital, product, and labour markets (Khanna et al., 2005), business groups are considered as the best structure to run businesses, as business groups are deemed a substitute to solve problems that arise due to market imperfections (Khanna and Rivkin, 2001; Chang and Hong, 2002). Affiliated firms are typically linked to each other in a business group through cross-shareholdings and/or a pyramidal structure (La Porta et al., 1999; Claessens et al., 2000), interlocking directorates (Silva et al., 2006), and inter-company transactions (Yeh et al., 2012; Nekhili and Cherif, 2011). Transaction costs can be reduced as members of a business group can easily share key officers (Silva et al., 2006), intangible assets and innovations (Hsieh et al., 2010; Chang and Hong, 2000), and preferential loans (Berkman et al., 2009; Johnson et al., 2000).

Inter-company transactions or related party transactions are pervasive among affiliated firms in business groups. These transactions are deemed more efficient than arm’s-length transactions (that is, a market-based system) because they are based more on informal and personal relations (Li, 2003). The costs of such transactions are low due to speedy decision-making and a solid commitment within the group. However, related party transactions may also lead controlling shareholders to expropriate minority shareholders (Villalonga and Amit, 2006; Gonenc and Hermes, 2008; Utama et al., 2010; Juliarto et al., 2013; Du et al., 2013). For instance, a parent company may lend money to its subsidiaries with interest rates below the market rate. The controlling shareholders of
the business group may extract benefits from such a transaction at the cost of other (minority) shareholders.

A relation-based system also signifies that firms are likely to build political connections in order to reduce environmental uncertainty (Morck and Yeung, 2004; Hillman et al., 2009). As market mechanisms are less pronounced, firms try to get favouritism and obtain preferential access to resources by establishing political connections. In return, they need to pay politicians and government officials for getting access to these preferential resources. The presence of politically connected firms is more prevalent in jurisdictions with highly corrupt practices (Luo, 2002; Faccio, 2006; Wu, 2009). Because the nature of corruption is secretive, firms with political connections are inclined to be more opaque (Leuz and Oberholzer-Gee, 2006; Chen et al., 2010), riskier (Bliss et al., 2011; Wahab et al., 2011), and to expropriate minority shareholders (Habib et al., 2017). Lack of transparency and weaker mechanisms of corporate control are believed to be main contributors as to why corruption tends to breed (Faber, 2005; Sullivan 2009; Halter et al., 2009; Bauhr and Grimes, 2017).

1.3 Research Questions

The central theme of the thesis is to examine how internal and external corporate governance mechanisms can mitigate opportunities for managerial misconduct. In particular, we aim at addressing how external and internal corporate governance mechanisms can control misconduct by corporate managers in the context of Indonesia. On the basis of this objective, the main research questions of this thesis are the following:

1. Does a strong institutional framework mitigate opportunities for corruption (Chapter 2)?

2. What factors determine external auditors when assessing fraud risks (Chapter 3)?
3. Does a change of the institutional landscape influence the value of politically connected board members (Chapter 4)?
4. Do board characteristics improve transparency and mitigate earnings management practices (Chapter 5)?

To answer these research questions, we carry out four empirical studies, using data from Indonesia, to investigate how various corporate governance mechanisms may contribute to disciplining managers and controlling managerial misconduct. Figure 1.1 presents the corporate governance mechanisms dealt with across the four empirical studies. These studies analyse two external mechanisms (i.e., institutional framework, external auditors), and two internal mechanisms (i.e., the characteristics of the board of commissioners\(^3\), transparency). The first study (chapter 2) investigates the role of Indonesia’s institutional framework of corporate governance in controlling the opportunities for corruption. The second study (chapter 3) examines the perceptions of external auditors when assessing fraud risks. The third study (chapter 4) investigates the interaction between the board of commissioners and directors (internal mechanism) and the change of the institutional framework (external mechanism) (see the dashed line in figure 1.1), and its impact on the extent to which firms that have directors with political connections perform differently from firms without these connections. The fourth study (chapter 5) analyses the link between board characteristics (internal mechanism), transparency (internal mechanism) (see the dashed line in figure 1), and earnings management. The details of each study are discussed in section 1.5.

\(^3\) Indonesia adopts a two-tier board system in which there is a clear separation between the supervisory board and the executive directors. Pursuant to Law No. 40 year 2007 on Limited Liability Companies, the supervisory board is called the Board of Commissioners (Dewan Komisaris in Indonesian), while the executive directors is called the Board of Directors (Direksi in Indonesian). The function of commissioners is the same as non-executive directors in a one-tier board system.
1.4 Theoretical Background

Two theories are central to the analysis in the four studies i.e., agency theory and resource dependence theory. Each theory is briefly discussed below.

1.4.1 Agency theory

Agency theory originates from the theory of the firm. This theory has been developed by several prominent scholars such as Smith (1776), Berle and Means (1932), Coase (1937), and Jensen and Meckling (1976). The theory acknowledges that when management and ownership of a firm are split, which is the case for stock-based firms, this may have consequences with respect to managerial behaviour. When managers are appointed to operate a business on a daily basis without directly being controlled by the shareholders, managers may run the business not in line with the interests of the shareholders. This phenomenon was described as follows by Smith in his book entitled An Inquiry into the Nature and Causes of the Wealth of Nations: “The directors of such companies, however, being the managers rather of other people’s money than of their own, it cannot well be expected that they should watch over it with the same anxious vigilance with
which the partners in a private copartnery frequently watch over their own” (Smith, 1776, p.311).

Two hundred years later, in 1976, Jensen and Meckling in their seminal paper developed a theory of the ownership structure of the firm, which integrated the ingredients of agency theory, property rights theory, and finance theory (Jensen and Meckling, 1976, p.1). According to Jensen and Meckling, a firm is formed by selling stocks, which are held by many different investors. In this way, it is impossible for the shareholders to operate the business by themselves. They need other persons to run the business. The segregation between owners (principals) and managers (agents) may result in conflicts as the principal’s interests may diverge from those of the agent’s.

Since then, the agency theory has become a powerful tool to analyze potential conflicts of interest between principals and agents, not only in the area of economics but also in other fields such as political science and sociology. Jensen and Meckling (1976) offered two primary measures to reduce agency costs (that is, the costs of the separation of ownership and control): control (monitoring) mechanisms, and managerial incentive mechanisms. Monitoring mechanisms are intended to restrict the agents’ misbehaviour in order to be aligned with shareholders’ interests. These include costs associated with providing reliable and transparent financial statements, and the presence of independent directors. This dissertation utilises this theory in Chapters 2, 3, 4, and 5.

1.4.2 Resource dependence theory

The resource dependence theory stresses that organizations are dependent on resources. Organizations have to compete to obtain limited resources, in order to survive and mitigate environmental uncertainty. The theory was introduced by Pfeffer and Salancik (1978) in their book *The External Control of Organizations*. Although this theory is not as dominant as agency theory, it has been widely used by corporate governance scholars (Hillman *et al*., 2009). One of the strategies that companies may take is by recruiting board members with specific characteristics aligned with the needs of the
Board capital consists of human capital (experience, expertise, skills, reputation), and relational/social capital (networking) (Hillman and Dalziel, 2003).

Research using resource dependency theory has examined the importance of board members in increasing firm performance by bringing valuable resources to the company, such as competence and experience (Sellevoll et al., 2007; Martikainen et al., 2016), multiple board appointments (Ferris et al., 2003; Jiraporn et al., 2008; Clements et al., 2015; Muravyev et al., 2016), foreign directors (Masulis et al., 2012; Polovina and Peasnell, 2015), and networking (Hillman, 2005; Stevenson and Radin, 2009; Hoitash, 2011; Johnson et al., 2013b). We use resource dependency theory in chapter 4 when we discuss the connections board members have with politicians. These connections may be a valuable resource to the company, which at least potentially may increase its financial performance.

1.5 Structure of the Thesis

The thesis is divided into six (6) chapters. Chapter 1 is the introductory chapter, which describes the objectives, the research questions, and the content of this thesis. Chapters 2, 3, 4, and 5 provide four (4) empirical studies, which analyse various corporate governance mechanisms in Indonesia. The central topic of these four studies is related to how these corporate governance mechanisms can control the opportunities for managerial misconduct (see also Figure 1.1). Chapter 6 concludes and discusses the main findings of the study. Table 1.1 summarises the four empirical studies in the dissertation.

Chapter 2 presents a comparative study of institutional corporate governance frameworks in Malaysia, Thailand, and Indonesia. It provides a basis to understand the main characteristics of corporate governance in Indonesia, and how Indonesia has developed its institutional framework as compared to Malaysia and Thailand. This study contributes to the literature as previous research on corruption has been mainly
Table 1.1 Summary of the empirical studies of the dissertation

<table>
<thead>
<tr>
<th>Chapter</th>
<th>Theory and governance mechanism</th>
<th>Research questions</th>
<th>Methodology and sample</th>
<th>Variable of interest</th>
</tr>
</thead>
<tbody>
<tr>
<td>2</td>
<td>Agency theory</td>
<td>How can an improved institutional framework for corporate governance decrease the level of corruption? How does the corporate governance institutional framework of Indonesia compare to that of Malaysia and Thailand?</td>
<td>- A comparative study - Indonesia, Malaysia, and Thailand - 2014</td>
<td>Corporate governance codes, capital market regulations, listing rules</td>
</tr>
<tr>
<td>3</td>
<td>Agency theory</td>
<td>Do fraud risk factors, materiality judgments, professional scepticism, litigation risk determine fraud risk assessments?</td>
<td>- A questionnaire-based study - 435 external auditors - 2015</td>
<td>Fraud risk factors, materiality judgments, professional scepticism, litigation risk</td>
</tr>
<tr>
<td>4</td>
<td>Agency theory and resource dependence theory</td>
<td>Does an institutional change influence the value of political connections?</td>
<td>- A quantitative study - 2,877 observations - From 2000 to 2011</td>
<td>The political landscape change</td>
</tr>
<tr>
<td>5</td>
<td>Agency theory</td>
<td>Do board inputs improve transparency and mitigate earnings management?</td>
<td>- A quantitative study - 245 observations - From 2013 to 2015</td>
<td>The mediation effect of disclosure &amp; transparency</td>
</tr>
</tbody>
</table>

dominated by studies focusing on the macro/country level and using a quantitative approach. These studies focus on issues such as the causes of corruption (e.g., Glaeser
and Shleifer, 2002; Bohara et al., 2004; Schulze and Frank, 2003), the negative effects of corruption on investment (e.g., Wei, 2000; Gyimah-Brempong, 2002), and the determinants of corruption (e.g., Martin et al., 2007; Zhou et al., 2012). However, research on the importance of corporate governance in curbing corruption has not been much investigated (Wu, 2005).

Our study makes a contribution to the research on the relationship between corporate governance and curbing corruption by examining the three countries’ institutional frameworks which consist of corporate governance codes, company law, rules and regulations. Particularly, three components of corporate governance mechanisms are evaluated i.e., shareholder rights, the board of directors, and the accounting and auditing standards including transparency standards. The hypothesis of this chapter is that a strong corporate governance institutional framework can reduce opportunities for corruption. In general, our study supports the hypothesis, that is, Indonesia’s corporate governance institutional framework is less strong than Malaysia and Thailand, leading to a weak monitoring system. This condition makes the opportunities for corruption more unimpeded.

The quality of institutions influences how well economic resources are allocated among various parties (Acemoglu et al., 2005). Corporate governance mechanisms are part of the country’s institutional framework, directing the interrelationship between shareholders, board of directors, management, and other stakeholders (Cuervo, 2002). By strengthening corporate control mechanisms, the business sector can contribute to putting in place measures that ensure that business transactions are performed with higher levels of integrity and reduced levels of misbehaviour, including corruption. Sound corporate governance practices may promote investment and economic growth (Claessens, 2006; Tiwari, 2010).

Chapter 3 focuses on external auditors’ perceptions of a fraud case. External auditors are part of the external corporate governance mechanisms. They are responsible for performing the audit of a firm’s financial statements to assure that the financial reporting is free from material misstatements due to fraud or error. External auditors
have responsibilities for identifying and assessing fraud risks (ISA 240, 2009). Because they play a significant role in identifying and assessing fraud risks, it is important to study factors that influence fraud risk assessment. To do so, we develop a vignette case study, which describes a real fraud case in Indonesia. Referring to the vignette case, we conduct a questionnaire which is distributed among Indonesian external auditors.

We extend the model of auditor judgments in assessing fraud risk as developed by Hammersley (2011) by adding three variables of interest: materiality judgment, professional scepticism, and litigation risk. While previous studies have investigated factors that influence fraud risk assessments, such as scepticism (Boyle et al., 2015) and fraud risk factors (Moyes, 2008; Johnson et al., 2013) independently from each other, our research model predicts that external auditors’ fraud risk assessment is determined by fraud risk factors, materiality judgment, professional scepticism, litigation risk, and several auditor characteristics (certification, experience, and audit firm size) simultaneously. Using Structural Equation Modelling, the results indicate that fraud risk factors, materiality judgment, and professional scepticism are crucial factors for external auditors when assessing fraud risks. More importantly, the results show that professional scepticism mediates the relationship between materiality judgment and fraud risk assessments. These results are deemed new in the auditing literature.

Investigating auditor judgments in assessing fraud risk is relevant, particularly for Indonesia. The quality of audits in this country is generally low. Audit practices are characterized by insufficient audit planning and low scepticism of fraud and misstatements, and they are less critical of management assertion (ROSC, 2011, 2018). This also means that there is much room to increase the number of certified accountants and to improve auditor capacity. The number of licensed Certified Public Accountants (CPAs) is very limited, only 1,350 (Finance Professions Supervisory Center, Pusat Pembinaan Profesi Keuangan, 2015). The Indonesian Institute of Certified Public Accountants (IICPA) has created, and should continue to create, various programmes to attract accounting graduates and auditors in order to become a CPA.
Chapter 4 portrays how institutional change in Indonesia during the early 2000s affected the value of political connected firms. Particularly, we compare the financial performance of politically connected firms and non-politically connected firms between the pre-democratic era period (before 2005) and the democratic era period (after 2004). The year 2004 is deemed a milestone entering the democratic era because Indonesia for the first time ever introduced direct democratic presidential elections. Employing hand-collected data on politically connected board members of 357 listed non-financial Indonesian firms over the 2000-2011 period, the empirical results show that the financial performance of large firms with political connections is higher than that of the performance of large firms without such connections. We also find that the financial performance of business group firms with political connections is higher than the performance of business group firms or stand-alone firms without such connections. Yet, in the democratic era the positive impact of political connections on performance weakens. We interpret these findings as evidence that political connections became less important for firms as a determinant of their performance after the Indonesian political landscape changed to a more democratic regime.

Only a few studies have investigated the effect of institutional change on the relationship between political connections and firm performance (Siegel, 2007). So far, most of the work on the impact of political connections has regarded the institutional context as constant (given). In addition, the studies of politically connected firms in Southeast Asia commonly use data before or during the Asian crisis (e.g., Fisman, 2001, Johnson and Mitton, 2003; Imai, 2006; Faccio, 2006; Leuz and Oberholzer-Gee, 2006; Polsiri and Jiraporn, 2012). Our study is the first using longitudinal data, investigating the impact of institutional changes on the performance of Indonesian PCFs which for the period 2000-2011.

Chapter 5 describes the interrelations between board inputs, transparency, and earnings management. Prior research has documented the direct association between board characteristics and earnings management (e.g., Peasnell et al., 2005; Rahman and Ali, 2006; Carcello et al., 2008; Jaggi et al., 2009; Jackling and Johl, 2009; Marra et al., 2011;
Khalil and Ozkan, 2016; Marra et al., 2011; Chen et al., 2015). However, the results of these studies are inconclusive. While all those studies assume a direct relationship between board performance and earnings management, this study takes a different stance. We argue that the association between boards and earnings management is not necessarily direct. The main hypothesis is that board inputs affect earnings management indirectly, by influencing the extent to which management is transparent (Cheng and Courtenay, 2006; Rao and Tilt, 2016). Board inputs determine the level of transparency and disclosure, which in turn mitigates earnings management practices.

Three constructs are developed to measure the level of board inputs, i.e. board skills, board commitment, and board structure. The constructs are composite indices created from selected questions based on the ASEAN Corporate Governance Scorecard, which is provided by the Indonesian Institute for Corporate Directorship. The sample consists of 104 listed non-financial Indonesian firms for the years 2013, 2014, and 2015. The findings show that board skills and board commitment reduce earnings management indirectly through mandatory disclosure, but not through voluntary disclosure. Moreover, we find that Indonesian firms have not fully complied with mandatory disclosure requirements.

Our findings suggest that a lack of compliance is a big concern for emerging countries in general and for Indonesia in particular. This may occur because board members may be less effective in their monitoring role. They may be less strict to enforce higher disclosures. Among other things, this may be caused by the fact that regulatory bodies do not impose any penalty for non-compliant firms. It seems that enforcement of regulations is weak. Therefore, corporate governance mechanisms such as having effective boards and imposing formal regulations do not necessarily result in good implementation of corporate governance in practice.

Lastly, chapter 6 provides the highlights of the main findings. The four empirical studies contribute to a deeper understanding of corporate governance practices in Indonesia. First, much improvement has been achieved with regard to the corporate governance institutional frameworks. However, the strong institutional frameworks do
not necessarily imply that all firms comply with the rules and regulations. The Indonesian corporate governance framework is mostly voluntary based. This means it is less stringent in practice. Second, our findings also suggest that the capacity of the supervisory directors needs to be improved. Although the independence board structure may be satisfied, the board members are less effective in carrying out their monitoring duties. Third, the financial reporting and audit quality are another big concern. The audit quality can be improved when auditors demonstrate more conservative and more sceptical behaviour, which may lead to increased fraud risk assessments.

In addition, chapter 6 also discusses the practical implications and policy recommendations. Policy makers and regulators such as the Financial Services Authority (OJK) are necessary to focus more on the enforcement of law and regulations. The enforcement division may consider being more stringent to penalise firms that do not comply with the regulations. A more conducive environment for market-based mechanisms should be promoted. For instance, channels for shareholder activism need to be created therefore, shareholders can easily voice their opinions. For corporations, a strong commitment to implement sound corporate governance mechanisms is a must.
Introduction