Chapter 6
Conclusions

Corporate governance is a broad concept which involves law and regulations, codes, policies and procedures. The purpose is to provide control mechanisms that direct the relationships between a company’s management, its board, its shareholders and other stakeholders (OECD, 2015). Various corporate governance best practices have been developed to help companies implement them. However, in reality corporate governance practices vary across countries. It is argued that certain corporate governance prescriptions do not necessarily translate into similar outcomes and often ‘one size does not fit all’ (Hermes et al., 2006; Hofstetter, 2006; Arcot and Bruno, 2007; Osma and Noguer, 2007; Davies and Schmitz, 2008; Yoshikawa, 2015).

Variations in corporate governance practices are determined by several forces such as legal tradition, the economy and capital market development (Aguilera and Jackson, 2010; Daniel et al., 2012; Cumming et al., 2017). Prior research has shown that the diversity of institutional environments shapes the effectiveness of corporate governance mechanisms (Young et al., 2004; Berglöf and Claessens, 2006; Pejovic, 2011). Therefore, taking into account the institutional context is crucial to better understand how well the implementation of corporate governance mechanisms.

This dissertation aims at exploring how corporate governance practices are implemented in a fast growing, middle-income country. Many studies have traditionally regarded Indonesia as having weak investor protection and, weak enforcement of law (Goyal and Muckley, 2013; La Porta et al., 2000), and low risk of litigation (Fitria et al., 2016). Even though corporate governance practices in Indonesia have improved considerably over the past decade, the actual implementation of the practices still lags behind.
Particularly, the dissertation investigates external and internal corporate governance mechanisms which may discipline managers and control managerial misconduct in Indonesia. The external mechanisms that we investigate are the institutional framework and external auditors, while the internal mechanisms are the board of directors and transparency. Four empirical studies have been carried out to answer the following research questions:

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

In chapter 2 of the thesis, we review the corporate governance institutional framework to better understand the rules and regulations that regulate shareholders, board of directors, accounting and auditing standards, and transparency. The results provide insight into the importance of the institutional framework with regard to controlling misbehaviour. In chapters 3-5, we further investigate the components of corporate governance mechanisms i.e., external auditors, board of commissioners and board of directors, and transparency. We select these mechanisms because we deem them important for the governance of firms in an emerging economy such as Indonesia.

In particular, boards are responsible for monitoring and ensuring that management always complies and runs business at the best interests of shareholders. As part of the internal mechanisms, board members encourage firms to be transparent. In addition, they also control managers from engaging in earnings management practices. To assure that management performs properly, it is necessary to be assessed by external parties, such as external auditors. Competent and qualified auditors are required to supply an objective opinion that a company’s financial reporting is free from material
misstatements and errors. Besides monitoring, the role of board members is to deliver services by providing advice. Board of commissioners or board of directors who have valuable resources such as political connections, may contribute, or even harm financial performance. Yet, their impact on firm performance depends on the institutional landscape.

The main findings of the four empirical studies are presented below, followed by a discussion of practical implications and policy recommendations, and avenues for future research.

6.1 The Main Findings of Each Study

The thesis consists of four (4) empirical studies, which are presented in Chapters 2, 3, 4, and 5. Each chapter provides analyses regarding corporate governance mechanisms in Indonesia. Table 6.1 summarises the main findings of the four empirical studies in the dissertation.

The first study (chapter 2) explores the role of institutional frameworks in constraining opportunities for corruption. The quality of institutional frameworks renders a basis for the implementation of corporate governance mechanisms. This study applies a qualitative approach focusing on comparing Indonesia’s corporate governance institutional framework (code, laws, rules, and regulations) to the framework developed in neighbouring countries i.e., Malaysia and Thailand. We evaluate corporate governance measures in the areas of shareholder rights, board of directors/commissioners, and the accounting and auditing standards including transparency. The main finding of the study is that Indonesia’s corporate governance institutional framework is weaker than that of Malaysia and Thailand.
Table 6.1 Summary of the main findings

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<th>Objective</th>
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| 2       | To investigate the role of the institutional framework in mitigating opportunities for corruption | - A better developed institutional framework for corporate governance can mitigate opportunities for corruption. | - Indonesia’s corporate governance institutional framework is weaker than in Malaysia and Thailand.  
- Indonesia’s corporate governance institutional framework is less demanding and less often enforced, which leads to greater opportunities for corruption. |
| 3       | To investigate the determinants of auditors’ decision making in fraud risk assessments | - Fraud risk factors are positively associated with fraud risk assessments.  
- Materiality judgments are positively associated with fraud risk assessments.  
- Professional scepticism is positively associated with fraud risk assessments.  
- Litigation risk is positively associated with fraud risk assessments. | - Fraud risk factors, materiality judgments, and professional scepticism positively influence external auditors when assessing fraud risks.  
- More conservative behaviour (by lowering materiality thresholds) increase auditors’ scepticism that leads to increased fraud risk assessment.  
- Immaterial misstatements are perceived to be less litigious by external auditors. |
| 4       | To investigate the impact of a substantial change in the political and economic framework of the economic value of political connections. | - The value of political connections is lower in the democratic era as compared to the pre-democratic era. | - The value of political connections has become less important in the democratic era (after 2004).  
- Politically connected firms tend to have lower performance than non-politically connected firms.  
- Large firms and affiliated firms that belong to a business group and have political connections tend to obtain more benefits than small firms and stand-alone firms. |
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| 5       | To investigate the interrelationships between board inputs, transparency, and earnings management | - Each board input (board skills, board commitment, board structure) is negatively associated with the level of earnings management.  
- Each board input (board skills, board commitment, board structure) is positively associated with the level of information disclosure  
- Disclosure positively mediates the relationship between each board input and earnings management | - Board skills, board commitment, and board structure are not associated with the level of earnings management.  
- Board skills, board commitment, and board structure are positively associated with the level of information disclosure  
- Board skills and board commitment mitigate earnings management indirectly through mandatory disclosure (but not voluntary disclosure). |

Shareholder rights in Indonesia, particularly minority shareholders, are less protected. Corporate decisions are mostly in the hands of controlling shareholders, and minority shareholders are likely to have difficulties in participating in the corporate decision-making process. One of the channels to expropriate minority shareholders is through Related-Party Transactions (RPT). Unlike Malaysia and Thailand, Indonesia does not have a provision or regulation concerning a requirement to seek advice from the supervisory board members or the audit committee before exercising a significant related-party transaction. This circumstance makes it easier for insiders (inside shareholders and management) to carry out abusive related-party transactions, which may be detrimental to outside shareholders.

International best practices stipulate several measures pertaining to the board of directors such as board independence, term limitation, and restrictions on the number of directorships a person may hold simultaneously. Our study reveals that Indonesia’s regulations regarding the board of commissioners and the board of directors tend to be
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less regulated. For instance, there are no rules with respect to the independence of the chairman, and/or the maximum age and term limits for commissioners and directors.

With regard to transparency, Indonesia did not apply a comply-or-explain approach until December 31, 2016.\textsuperscript{46} This means that Indonesian listed companies were not required to report to what extent the companies comply with the corporate governance codes and principles. In addition, there is no mandatory requirement for the board of commissioners to disclose potential conflicts of interest when they are involved in a related-party transaction or when they are related to a political party or the government. Board remuneration, the board nomination and selection process and audit fees are also not necessary components a firm needs to report about in the annual report.

In general, we conclude that the Indonesian corporate governance framework is mostly voluntary based. Because the institutional frameworks are less demanding and less enforced, companies have more room to diverge from best practices in corporate governance. This may provide stronger opportunities for managerial misbehaviour.

The second study (chapter 3) surveys 435 external auditors’ perception on a fraud case. When conducting the audit of a firm’s financial statements, external auditors are responsible for assessing fraud risks to assure that the financial reporting is free from material misstatement due to fraud or error. Contrary to prior research that estimates the fraud risk assessment model using a multiple regression, 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 findings confirm that fraud risk factors (red flags), materiality judgment, and professional scepticism positively influence external auditors when assessing fraud risks. More importantly, the research finds that materiality judgment affects fraud risk assessments indirectly through professional

\textsuperscript{46} The Financial Services Authority (OJK) introduced Regulation No.21/POJK.04/2015 dated November 16, 2015. The regulation requires listed firms to report and disclose their corporate governance implementation on the basis of the comply-or-explain approach that should be applied for the 2016 annual reports onwards.
scepticism. These findings imply that conservative behaviour (by lowering materiality thresholds) is important because it increases auditors' scepticism, leading to increased fraud risk assessments. Auditors also perceive that when a misstatement is less material the litigation risk tends to be lower, that is, the probability of being sued is lower. Generally speaking, the main finding of the research is that conservatism and professional scepticism are critical factors that help improving the quality of audits.

Next, chapter 4 investigates the effect of political and economic change in Indonesia on the value of political connections to firms. The study is the first using longitudinal data for the 2000-2011 period. We use hand-collected data on politically connected board members of 357 listed non-financial Indonesian firms. To analyse the effect, the data are split into the pre-democratic era period (2000-2004) and the democratic era period (2005-2011). We investigate the financial performance of politically connected firms and non-politically connected firms for the pre-democratic era period as compared to the democratic era period.

As hypothesised, the empirical results show that in the democratic era the impact of political connections on financial performance is reduced for both small and large firms. In other words, the value of political connections became less important after Indonesia went into a more democratic regime after 2004. One of the lessons of the analysis is that when markets are decentralised, access to economic resources becomes more open. In the democratic era, a shift of power occurred from the central government to the local government. The power of the central bureaucrats declined, leading to lower financial performance for firms having political connections with them. Businessmen could no longer depend only on the centralised authority, but rather had to connect to regional leaders and local politicians to have access to necessary resources.

Chapter 5 examines the interrelations between board inputs, transparency, and earnings management. While previous studies assume a direct relationship between board performance and earnings management, this study takes a different view. The main hypothesis of this study is that the relationship between board characteristics and earnings management is not necessarily direct. Three steps are performed i.e., first, the
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association between board inputs and earnings management; second, the association between board inputs and the level of transparency and disclosure; and third, the association between board inputs and earnings management through transparency and disclosure. Three constructs are developed using data from the ASEAN Corporate Governance Scorecard to measure board inputs, i.e. board skills, board commitment, and board structure.

The results show that board inputs are not directly associated with earnings management; however board inputs are positively associated with the level of transparency and disclosure. In addition, the research also supports our main hypothesis that board skills and board commitment (but not board structure) mitigate earnings management indirectly through mandatory disclosure, but not through voluntary disclosure. These results imply that mandatory disclosure plays an important role as a mediating factor between board inputs and earnings management.

6.2 Policy Recommendations

Based on the analyses and the main findings, the empirical studies in this thesis have several practical implications and policy recommendations that will be discussed below.

As discussed in chapter 2, section 4, shareholder rights in Indonesia are less protected by law and market-based mechanisms are rarely implemented. In particular, the market for corporate control is almost non-existent in Indonesia. This also means that shareholders who want to change the CEO and/or board members who underperform have hardly any means to do so. This results from the fact that shareholder rights in Indonesia are not well protected. A more conducive environment for market-based mechanisms may therefore need to be encouraged. Capital market regulators and changes in business law may facilitate the creation of channels for shareholder activism, allowing shareholders to more easily voice their opinion. It is crucial to strengthen their rights to question, to challenge and to make proposals.
Furthermore, the voting system needs to be improved. For instance, if shareholders are not able to attend the shareholders’ meeting, they could be allowed to vote by mail. As another example, the minimum share capital that is needed to call a shareholder meeting could be reduced. These types of reforms support shareholders to become more actively involved in monitoring company management.

As indicated in our analyses of the importance of transparency in reducing earnings management (chapter 5), Indonesian listed companies tend to not fully comply with mandatory requirements regarding corporate governance best practices. Lack of effective monitoring of compliance with regulations is particularly a big concern in emerging economies. Policy makers and regulators such as the Indonesian Financial Services Authority (OJK) are necessary to monitor the enforcement of law and regulations. In emerging economies such as Indonesia, enforcing compliance with mandatory requirements may have to become more stringent in penalizing firms that do not comply with the regulations. Our findings indicate that the quality of the boards (in terms of skills, commitment, and independence) is not enough to make sure firms comply with mandatory requirements regarding good corporate governance. The monitoring role of the boards of Indonesian firms needs to be strengthened. More strict enforcement of requirements by regulating bodies may be one way to achieve this.

More specifically, with regard to strengthening board skills and competencies, regulatory bodies such as the OJK and the Indonesia Stock Exchange could introduce provisions that mandate the setup of nomination and remuneration policies, the continuing professional education for board members, and an annual performance assessment of the board of commissioners. Furthermore, to improve board commitment, companies could limit the number of directorships of their board members.

Regulations pertaining to transparency need to be extended in order to align with international best practices. In Indonesia there are no regulations that require listed companies to disclose audit fees, nomination and remuneration policies for the board of directors, and conflicts of interest that the board members may have. Board members should report and disclose their position with the government and/or political party,
which may be deemed to bear conflicts of interest. The absence of these regulations makes it easier for companies to conceal significant information that may contain unobserved or non-arm’s-length transactions.

In the era of democratisation and open markets, transparency is a prerequisite. Economic resources are distributed more evenly and fairly across regions. The central government no longer has full control over economic resources. To ensure that economic actors can fairly access resources, it is necessary to set up mechanisms that stimulate easiness in doing business. As reflected in chapter 4, the power of the central government has diminished in the democratic regime. The authority shifting from the central government to local governments has an impact on business. Business activities are no longer concentrated in the centre of the country, but more dispersed over different regions. As a consequence, business actors may have to build relationships with local bureaucrats.

In addition to transparency, accountability is also vital. Reliable financial reporting and auditing promote confidence not only to the capital market but also to the public. To serve and protect the public interest, independent auditors are important to provide assurance that the financial reporting of firms is free from material misstatements due to fraud or error. As mentioned in chapter 3, in Indonesia the quality of audits is low. Audits are characterised by insufficient audit planning, a lack of scepticism related to possible fraud and misstatements, and a lack of management questioning and criticism. Our empirical results have various practical implications. Most importantly, our results suggest that auditors have to improve their professional competence, particularly in the area of materiality judgment and scepticism. Auditors should be encouraged to behave more conservatively (by lowering the materiality threshold) and to be more sceptical, which will lead to an increase in critical fraud risk assessments.
6.3 Future Research

The dissertation explores corporate governance practices in the Indonesian context. Therefore, the results in principle only hold for the specific jurisdiction. However, we do believe that the empirical research offers insightful analyses that may inspire researchers to do similar research in other countries with different institutional frameworks. For instance, the fraud risk assessment research can be replicated in countries with higher litigation risk to investigate how auditors engaged in more litigious countries have different perceptions of fraud risk assessments.

Referring to the political connections research, it focuses only on accounting indicators to measure firm performance. Further research may utilise other variables measuring company performance or decision-making to see how political connections do influence them. Examples could be testing the relationship between political connections and market value, access to and costs of bank loans, and acquiring government procurement projects. This type of analysis helps to understand the channels through which political connections may provide benefits to firms. In addition, the analysis of the interplay between business and local bureaucrats in the democratic era would be an interesting topic for future research.

In November 2015, the Indonesia Financial Services Authority (OJK - the regulatory and supervisory agency) introduced a new regulation, which requires publicly listed companies to implement the comply-or-explain approach when it comes to complying with corporate governance best practices. The regulation imposes publicly listed companies to follow corporate governance best practices. Violation of the comply-or-explain rule may result in sanctions from OJK. Future research may analyse the impact of the new regulation on the quality of corporate governance of Indonesian firms.