Summary

Corporate governance refers to the ways in which the stakeholders of a company make sure that their interests are taken into account by the management of a company. Corporate governance consists of formal and informal relationships between the board of a company and its stakeholders that determine how these interests will be met, how management reports about the decisions that should lead to the fulfilment of these interests, and how performance with respect to meeting these interests will be monitored (OECD, 1999). One important backbone of corporate governance research is agency theory developed by, among others, Jensen and Meckling (1976). Central to their theory is the notion of the separation of ownership and control. Their theory stresses that agents (managers) have self-interests, which may diverge from the interests of the principals (stakeholders) of the company. Based on this theory, they argue that effective monitoring through various corporate governance mechanisms should be prioritized to avoid deviant behaviour. These corporate governance mechanisms can be classified into internal mechanisms and external mechanisms (Walsh and Seward, 1990; Denis and McConnell 2003). Internal mechanisms deal with the internal organisation of a company, such as board of directors and shareholders, while external mechanisms operate through external factors such as the legal framework and capital markets (Cuervo, 2002; Gillan, 2006; Hanson and Song, 2006).

The dissertation aims at investigating how corporate governance mechanisms can mitigate opportunities for deviant managerial behaviour in Indonesia. As an emerging country, the corporate governance practices in Indonesia are different from developed countries. Since the early 2000s, Indonesia has improved its corporate governance practices through a better regulatory framework. However, Indonesia has been relatively slower in reforming corporate practices as compared to other developing countries in the Southeast Asia region (ADB, 2017).
The dissertation analyses two external mechanisms (i.e., the institutional framework and external auditors), and two internal mechanisms (i.e., the characteristics of the board of commissioners and transparency). Two studies present an analysis of a single mechanism (Studies 1 and 2); two other studies analyse a combination of two mechanisms (Studies 3 and 4). The interrelations of the mechanisms across the four empirical studies are depicted in Figure 1.

Figure 1. Corporate governance mechanisms

Study 1 sheds light on the role of the institutional framework (external mechanism) in mitigating opportunities for corruption. Study 2 deals with the perceptions of external auditors (external mechanism) when assessing fraud risks. Study 3 investigates the interaction between the board of commissioners and board of directors (internal mechanism) and the change of the institutional framework (external mechanism) (see the dashed line in figure 1), and its impact on the extent to which firms that have directors with political connections perform differently from firms without these connections. Study 4 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 presented below.

The first study (chapter 2) investigates the role of the institutional framework in controlling opportunities for corruption. It presents a comparative study of institutional corporate governance frameworks in Malaysia, Thailand, and Indonesia. Relying on agency theory, we argue that a strong corporate governance institutional framework can reduce opportunities for corruption. Three corporate governance measures with respect to shareholder rights, the board of directors, and the accounting and auditing standards, including transparency, are evaluated. The main finding of the comparative study is that, in general, Indonesia’s corporate governance institutional framework is less stringent than that of Malaysia and Thailand, which results in a weaker monitoring system. Because the institutional frameworks are less demanding and less enforced, this may provide stronger opportunities for corruption.

The second study (chapter 3) focuses on external auditors’ perceptions on fraud risk assessments. A survey of 435 external auditors is conducted, employing a vignette case study, which is adapted from a real fraud case in Indonesia. The research model predicts that external auditors’ fraud risk assessment is determined by fraud risk factors (red flags), materiality judgment, professional scepticism, litigation risk, and several auditor characteristics (such as certification, experience, and audit firm size). We find evidence that fraud risk factors, materiality judgment, and professional scepticism positively affect fraud risk assessments. Moreover, the analysis shows that materiality judgment influences fraud risk assessment mostly indirectly through professional scepticism. These findings have implications for auditors and their work, that is, they show that it is important for auditors to maintain a conservative behaviour by lowering materiality thresholds. This behaviour enhances auditors’ scepticism, which leads to increased fraud risk assessments. These results are deemed new in the auditing literature. Overall, the results suggest that the quality of audits can be improved when auditors demonstrate more conservatism and more sceptical behaviour.

The third study (chapter 4) examines how institutional change that occurred in 2004 in Indonesia affects the value of political connected firms. Drawing from agency
theory and resource dependence theory, the study is one of the few studies in using longitudinal data (2000-2011), investigating the impact of institutional changes on the performance of politically connected firms. The data are split into the pre-democratic era period (2000-2004) and the democratic era period (2005-2011) to enable us to measure the net effect of the institutional change on the value of political connections. The year 2004 is deemed a milestone 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, the empirical results show that in the democratic era the impact of political connections on financial performance diminishes for firms. These results indicate that the value of political connections has become less important after Indonesia went into a more democratic regime after 2004. These results can be explained by the fact that since 2004 there has been a shift of power from the central government to the local (regional) government. The power of the central bureaucrats declined, which led firms having political connections to have suffered in terms of their financial performance.

The fourth study (chapter 5) explores the interrelationships between board inputs, transparency and disclosure, and earnings management. While other studies assume a direct relationship between board characteristics and earnings management, this study argues that the association between boards and earnings management is not necessarily direct. Board inputs determine the level of transparency and disclosure, which in effect mitigates earnings management practices. Three board inputs are constructed using data from the ASEAN Corporate Governance Scorecard, i.e. board skills, board commitment, and board structure. Using a sample of 104 listed non-financial Indonesian firms for the years 2013, 2014, and 2015, the findings show that the board inputs are not directly associated with earnings management; they are, however, positively associated with the level of information disclosure. Most importantly, the results confirm that board skills and board commitment mitigate earnings management indirectly through mandatory disclosure, but not through voluntary disclosure, implying that mandatory disclosure acts as a mediating variable. In addition, the findings indicate that Indonesian firms have not fully complied with mandatory
disclosure requirements. This may occur because supervisory board members may be less effective in their monitoring role, or this may be caused by the fact that regulatory bodies do not impose strong enough penalties for non-compliant firms.

Overall, the results of the empirical studies suggest that strong internal and external corporate governance mechanisms are important for the performance of companies in an emerging economy such as Indonesia. The thesis shows that having sound corporate governance practices ensures that checks-and-balances are put in place to prevent misbehaviour. Investing in corporate governance is critical not only for long-run business sustainability, but also for the economy as a whole. The thesis also shows that transparency and accountability create public trust, which may lead to attracting investors and stimulating economic growth. Although the research has focused on Indonesia, we do believe our findings may also hold important lessons for other emerging countries. It would be interesting if the analyses we performed in the thesis were repeated in different country contexts. We leave performing comparative research for future research.
Summary