Corporate Governance and the Incidence of Sanctions in Indonesia Capital Market

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Corporate governance effectiveness; Indonesia corporate governance; sanctions; Indonesia capital market, two-tier board system, developing countries

Abstract

Indonesia has implemented good corporate governance principles since 2001 through the establishment of national committee and code that fully adopt the OECD Principles. However, World Bank–IMF (2004 and 2010) and Financial Standard Forum (2009) reported that corporate governance implementation in Indonesia has substantial discrepancies between what has been documented and its actual practices. In addition, the legal system differences and two-tier board structure might be accounted for this situation compared to other country practices.

This study argues that corporate governance practices in Indonesia are expected to prevent any sanctions. Thus the independent variables are corporate governance attributes such as ownership structure, board of commissioner, audit committee, and external auditor, while the incidence of sanction is the dependent variable. This study observes listed public companies in Indonesia for the period of 2007 to 2010 and using multinomial logistic regression model to measure the relationship.

The result shows that only top shareholder, board of commissioner (size and meeting frequency) and its audit committee meeting have significant relationship to the incidence of sanctions. Further, the model developed in this study has not strongly confirmed the effectiveness of corporate governance toward prevention of incidence of sanctions. These findings further confirm report by World Bank and IMF (2004 and 2010) and Financial Standard Forum (2009) about concentration of ownership for listed corporations and corporate governance discrepancies in Indonesia. Further research should extend the study using combination of quantitative and qualitative method and may introduce other measure of corporate governance effectiveness.

Introduction

The lack of prudent corporate governance practice has been identified as a significant contributor to the Asian economic crisis in 1997. In response to the crisis aftermath, Indonesia has implemented good corporate governance principles in the year 2001 through the establishment of Indonesia National Committee on Corporate Governance (INCCG) and The Indonesia Code of Good Corporate Governance that fully adopt the OECD Principles 1999. The Indonesia code also has been revised in 2006 following the issuance of 2004 OECD Principles revision. While OECD defines corporate governance as "a set of relationships between a company's management, its board, its shareholders and other stakeholders" (OECD 1999), INCG recognises the importance of good corporate governance as a key element for improving economic efficiency, economic growth and improving investor confidence.

Following the adoption of various corporate governance principles, the remaining issue is the assessment of effectiveness of corporate governance in Indonesia. On the one hand, reviews

by World Bank – IMF (2004 and 2010) through their Reports on the Observance of Standards and Codes (ROSC) highlighted that Indonesia has mostly incorporated good corporate governance principles into its regulatory framework in the form of law, regulation and sanctions. On the other hand, they also pointed out that the corporate governance practices in Indonesia are often distant from what the regulation and code requires, and they recommended that Indonesia should increase effectiveness of good corporate governance implementation and enforcement.

Furthermore, in November 2009, the Financial Standard Foundation, a non-profit organization that promotes transparency in political and economic affairs, awarded 'enacted' status to Indonesia based on the level of compliance to principles of corporate governance. 'Enacted' level means that the governance information is publicly available and the respective country has incorporated most of the principles into relevant laws and regulations, but the actual enforcement of laws and regulations has not been assessed.

Past studies mostly focused on the effect of corporate governance toward behaviors of management, company performance, reporting quality, and firm value (for example see Gompers, Ishii & Metrick (2003), Bhagat and Bolton (2008), Karamanou & Vafeas (2005), and Beasley (1996)). These studies seem to be less relevant to developing countries including Indonesia because the findings are inconclusive and country/regional specific. Further they are from the developed countries experiences.

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 in 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. Therefore, even the findings from other developing countries cannot be exactly used in Indonesia. Further, Indonesia adopts two-tier board system structure that differs from the one-tier system found in many other countries. The two-tier board structure refers to the separation between supervisory board that represent stakeholders and management board that manage company operation, as opposed to one-tier board system that combines the roles of chair and CEO (Clarke 2007). The differences in legal system may also affect the effectiveness of corporate governance. This argument is supported by Vafeas & Theodorou (1998:384) which argued that "various governance structure should be separately examined in each country".

For that reason, the analysis of effectiveness of corporate governance in Indonesia is an interesting area of research, especially by measuring its function to prevent any incidence of sanctions. Hence the objectives of the study are providing a comprehensive review of the corporate governance attributes and investigating relationship between corporate governance and the incidence of sanctions or enforcement actions in Indonesia capital market. Findings of this study could provide useful information and fill the gap identified in the ROSC report. Moreover, the observed relationship can be used as an evaluation tool by the regulators while reviewing the current corporate governance codes and regulations. In addition, the findings also can help the company in evaluating specific governance attributes that requires improvement to maximise its effectiveness.

Literature Review

Corporate Governance Theory

'The dissolution of the old atom of ownership into its component parts, control and beneficial ownership' (Berle & Means 1932) was a starting point of modern corporation. The separation

of control and ownership, and the fact that ownership of corporation is slowly diluted into more diverse holders and small fraction of ownership create further problem known as 'agency problem'. The different interests between owner as the 'principal' and management as the 'agent' are the source of agency problem (Jensen & Meckling 1976). Owner will put monitoring mechanism to control management interests and bear the monitoring costs. As this problem will always arise and could not always be settled by contractual agreement by owner and management in every occasion, there is a need to put regulation and control that restrict board and management activities in the form of good corporate governance (Baker & Anderson 2010). This agency theory is become one of the theoretical perspectives for corporate governance (Zahra & Peace 1989; Stiles & Taylor 2002 as cited in Clarke 2007).

OECD (1999 and 2004) defined Corporate Governance as a set of relationships between management, board of directors, company shareholders and its wider stakeholders, providing certain structure to attain company objectives and monitoring performance. This OECD definition has been adopted by various major international and national bodies, for example World Bank and the European Commission (Mason & O'Mahony 2008). The European Commission stated that the OECD definition of corporate governance is 'comprehensive' and emphasized that key governance problem is coming from interests' differences between management and shareholders (Commission of the European Communities 2003, cited in Mason & O'Mahony 2008). The goal for corporate governance is economic efficiency and effective corporate governance system in economy will produce greater confidence as an important aspect for proper functioning of market economy. These conditions will promote lower cost of capital, efficient use of resources and stimulating growth (OECD 2004).

Since 1999 the OECD Corporate Governance Principles was agreed as a basis for corporate governance initiatives among OECD members and non-members countries, and has been updated in 2004 (OECD 2004). The OECD Principles also become the basis for evaluation of World Bank and IMF for world Reports on the Observance of Standards and Codes (ROSC). The Principles are developed mainly to assist OECD and non-OECD countries to evaluate and improve their legal, institutional and regulatory framework for corporate governance. As the main focus of these principles is for public companies, they are also important for stock exchanges, investors, corporations and any parties involved in developing good corporate governance practices.

The OECD Corporate Governance Principles focus on the central problem of governance, which is separation of ownership and control. However, there are multiple factors affecting governance and decision making process within firm, therefore the Principles should be considered in conjunction with other governance issues such as issues of controlling shareholders over minority shareholders and briberies. The OECD Principle realised that there is no singles good model for corporate governance, therefore the Principles was composed of common elements to accommodate different models between nations. Moreover, it is a non-binding and not detailed prescription, hence it is only served as reference points for policy makers to develop legal and regulatory frameworks (OECD 2004). It is also evolutionary in nature and will be reviewed to accommodate significant changes and maintain competitiveness in rapid changing environment.

Indonesia Corporate Governance

In Indonesia, the Indonesia National Committee on Governance (INCG) was established in 1999 and issued a Code of Good Corporate Governance in 2001 that fully adopt the OECD Principles. The latest Code revision was in 2006 in order to keep update with the OECD Principles revision in 2004. INCG (2006) stated that the Indonesian Code of Good Corporate

Governance is a living instrument providing standard and guidance in implementing good corporate governance, and intended as reference points to all Indonesia companies (including Islamic operating companies) and offer some basic principles for minimum standards that could be adapted to specific circumstances.

In relation to rules and regulation of company law, the Indonesia Company Law 2007 stipulated that all entities with limited liabilities should have three organs that consist of General Meeting of Shareholders, Board of Commissioners and Board of Directors. The special 'two-tier board' structure is reflected in the body of Board of Commissioners and Board of Directors ("Dewan Komisaris" and "Dewan Direksi" respectively in Indonesian terminology). With reference to Anglo-Saxon model, the Board of Commissioners (Dewan Komisaris) has similar roles to the Board of Directors, while the Board of Directors (Dewan Direksi) has the same function as management/executives roles.

Board of Commissioners (Dewan Komisaris) has to supervise Board of Directors (Dewan Direksi) and give advice about company general policies, whereas Board of Directors (Dewan Direksi) is liable for company operation and making operational decisions. Members of both boards are elected by shareholders through General Meeting of Shareholders, however Board of Directors (executive management) has to report both to Board of Commissioners as supervisory board and to shareholders.

As the role of supervision and management are completely divided into two different boards (two-tier board arrangement), it is argued that Board of Commissioners could perform their supervisory duties more independently (Achmad 2007). In relation to the board effectiveness, Carter & Lorsch (2004) argue that board structure, board composition and board process are the important elements to create balance and coherence to perform effectively. In addition, the Indonesia company law prohibits that an individual sits in the both boards.

Board of Commissioners has committees in order to assist its member performing their supervisory duty. The committee members should at least consist of one of the Board of Commissioners members. The Indonesian code gives further guidance on the existence, roles, and functions of those committees. The Code recommends 4 (four) committees, which are Audit Committee, Nomination and Remuneration Committee, Risk Policy Committee, and Corporate Governance Committee. Clarke (2007) suggest that the existence of board subcommittees are in the spirit of enhancing direct accountability of the board as part of corporate reform in the last two decades.

As General Meeting of Shareholders is considered to be one important organ in a company, this mechanism facilitates shareholders to participate in the important investment decisions by observing and creating boundary on company's article of association and through the rules and regulation. The shareholders, especially the blockholders have affected the quality and comprehensiveness of oversight function to the management (Bourke 2006). Furthermore, Lukviarman (2004) argue that in Indonesia, the agency problem issue is not a conflict of interest between owner and manager, however it is a conflict between strong controlling shareholders and weak minority owners. Therefore, the concentration of ownership is one of important aspects of corporate governance. This is due to the "strength" voting power that the blockholders had so it would have positive bearing to the governance oversight (Persons 2006).

Corporate Governance Effectiveness

Despite all the importance of corporate governance implementation and the development of governance rating to measure the quality of corporate governance, the effectiveness of

corporate governance is remain a fundamental question for researchers and business community. Scholars have measured the effectiveness of corporate governance in term of their relationship with opportunistic behaviour of management, company performance, reporting quality, firm value and the incidence of sanctions/frauds.

Gompers, Ishii & Metrick (2003) research the relationship between corporate governance and agency costs. Based on agency theory, better corporate governance should lead to better performance in term of higher stock prices and lower agency costs. However, the positive association between corporate governance and firm performance may not relate with agency theory explanation.

Researchers such as Gibson (2003), Chuanrommanee & Swierczek (2007), Alijoyo et. al (2004), Epps & Cereola (2008), Klapper & Love (2004) and Bhagat, Bolton & Romano (2008) examine the effectiveness of corporate governance toward firm performance. Using corporate governance rating, Bhagat, Bolton & Romano (2008) conclude that there is no consistent relationship between corporate governance indices (as a proxy for governance quality) and firm performance. Furthermore, they argued that the effectiveness of corporate governance will depend on the firm context and firm specific circumstances. Chuanrommanee & Swierczek (2007) challenge the effectiveness of corporate governance for firm performances in Asia, whether it is a reality or illusion. Based on the rating given by Credit Lyonnais Securities Asia, they found that the company documentation of corporate governances do not necessarily reflect real/actual conditions and those practices do not have impact on company performances. Therefore, they argued that corporate governance in Asian is more an illusion than a fact (Chuanrommanee & Swierczek 2007).

Studies that evaluate the relationship between corporate governance and quality of company reporting revealed mixed results. Karamanou & Vafeas (2005) argue that firms with more efficient boards and stronger audit committee are likely to issue more forecasts and more accurate financial figures, and they found empirical evidences to support the positive association between effective corporate governance and higher financial disclosure quality. However, other studies by Koehn & Ueng (2005), Farber (2005), Myring & Shortridge (2010) show different results. Koehn & Ueng (2005) reveal that corporations with weak governance practices also provide financial information as good as firms with strong governance attributes. Recent research by Myring & Shortridge (2010) state that good corporate governance will not always impact to the quality of financial statement information as they find mixed evidences to support these relationships.

Other scholars (e.g. Gompers, Ishii & Metrick 2003; Brown & Caylor 2006) study the relationship between corporate governance and firm value. Gompers, Ishii & Metrick (2003) measure corporate governance practices using G-Index, a measurement of 24 firm-specific provisions, and revealed that more democratic firms are more valuable. Brown & Caylor (2006) also create a Gov-Score, a broad measurement of corporate governance practices based on 51 firm-specific provisions presenting both internal and external governance, and find that seven provisions underlying Gov-Score are fully related with firm value.

Corporate Governance and the Incidence of Sanctions/Frauds

The implementation of corporate governance principles should have impact on company daily operations including minimizing the incidences of any sanction or enforcement actions by regulator. Donker & Zahir (2008:88) argue that "good governance will only reduce fraud, save corporation money on director and officer insurance, lawsuits, and reduce business

failure". Furthermore, Mukweyi (2010:67) states that "good corporate governance should ensure that no stakeholder is fraudulently shortchanged by insiders in the firm".

With regard to the statements, the relationship between corporate governance and the occurrence of fraudulent activities is also an interesting area for 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) and Ezat & El-Masry (2008)).

Beasley (1996) study whether the style and the form of corporate governance has an effect for deterring financial fraud in the US. Uzun, Szewczyk & Varma (2004) examine the occurrence of US corporate frauds in the period 1978 – 2001 based on various characteristics of board of directors. They argue that board characteristics (composition and structure of board oversight committee) are significantly correlated with the incidence of firm's frauds. In addition, the increasing number of independent outside directors on a board as well as on audit committee and compensation committee will decrease the likelihood of corporate frauds. Bourne (2008) observe the inclusion of corporate governance index to the financial ratios as a predictor for fraudulent financial reporting. The author find that the inclusion of corporate governance index (Gov_Score Index) by Brown & Caylors (2006) become a statistically significant 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 firm's audit committee are solely comprised of independent directors and when the audit committee's member have smaller number of directorship with other companies. Moreover, Persons argues that board of director independence, audit committee expertise and nominating committee independence are not significant in reducing the likelihood of financial fraud. Furthermore, Persons (2006) also examines the likelihood of non-financial reporting fraud as a result of the implementation of corporate governance. The typical non-financial reporting frauds consist of fraud of consumers, fraud of government, and fraud of regulation violations. The study reveals that the probability of non-financial reporting frauds is lower when these conditions are met: larger proportion of outside independent directors, different person for CEO and BOD Chairman, smaller size of BOD, longer tenure for BOD Chairman, and when the firm profits are higher. Similar research by Bourke (2006) also reveals that most of corporate governance attributes are significantly related to the occurrence of fraudulent financial reporting in US listed firms, such as board of director's independence, the duality roles of CEO and board chairperson, and share ownership by outside block holders.

With regard to the occurrence of transfer pricing for related party transactions, Lo, Wong & Firth (2010) investigate the corporate governance structure that constraint opportunistic behavior of management of doing transfer pricing manipulation. They find that certain governance structures have higher percentage of independent directors or lower percentage of parent directors or different persons occupying the chair and CEO position or having financial experts on audit committee are reducing the likelihood of transfer pricing manipulation. They conclude that the quality of corporate governance is important to deter the transfer pricing manipulation.

In China, Jia et al. (2009) observe the relationship between the roles of supervisory board and the incidence of enforcement actions by regulator as well as stock exchange. They conclude that supervisory board has significant role when Chinese public companies facing enforcement actions. However, their finding is in the contrary of theoretical role of

supervisory board, in which the supervisory board is deemed to be ineffective in China. The findings reveal that larger supervisory board and more frequent supervisory board meeting will create more severe sanctions imposed by regulator or stock exchange. Chen et al. (2006) examine whether ownership structure and board characteristics have impact on corporate financial fraud in China. They find that board characteristics are more important than ownership structure, especially for proportion of outside directors, number of board meetings, and the tenure of Board Chairman.

Mangena & Chamisa (2008) also study the relationship between corporate governance structure under Anglo-Saxon regime for developing country and the incidence of listing suspensions by Johannesburg Stock Exchange (JSE) of South Africa (SA). They find that smaller proportion of non-executive directors, the non-existence of audit committee, and with greater block-share ownership and high leverage (debt), will likely increase the incidence of listing suspensions. However, no association is found for the board size, role of duality, directors share ownership, auditor quality and return on assets (Mangena & Chamisa 2008).

In relation to the timelines of reporting obligation for listed companies, Abdelsalam & El-Masry (2008) and Ezat & El-Masry (2008) study the impact of corporate governance on reporting timeliness for Irish and Egyptian listed companies. The studies find that in Irish listed companies, board of directors independence and CEO ownership have positive association with reporting timeliness, whereas in Egypt listed companies, especially for service industry, more independent directors, larger number of directors and dispersed ownerships are having positive impact to support timely reporting.

Study by Rosa, Filippetto & Tarca (2008) examine the relationship between enforcement actions and firms corporate governance structures. The research was based on the enforcement actions taken by Australian regulator (Australian Securities and Investment Commission – ASIC) to the targeted firms. The author find that firms being investigated by ASIC have weaker corporate governance scores compare to other companies that similar in period, size and industry.

Indonesia Enforcement Actions

The critical factor of the development of a capital market is the legal protection to the investors. The enforcement of laws and regulations has been seen as the same important as the substance of the laws and regulation, sometimes is viewed more important than the substance itself (Porta et al. 2002). In the context of supporting good corporate governance practices that significantly contribute to better investors protection, Defond and Hung (2004) contend that law enforcement agencies is more important than the investor protection laws. Such agencies are capital market regulator and law courts to protect investors right (Defond & Hung 2004).

In Indonesia, the Indonesia Capital Market Law 1995 regulates stock market and public companies activities. The Indonesian Capital Market and Financial Institutions Supervisory Agency (“Bapepam-LK”), which is now has transformed into Indonesian Financial Services Authorities (“OJK”) since 2013, is the government agency that regulating, supervising, and enforcing capital market activities in order to create an effective, efficient and transparent capital market. The Indonesia Stock Exchange (“IDX”), as a self regulatory organisation, also has authority to regulate and enforce its own regulation to all market participants. The regulators will enforce any violations of the law and regulations to any persons/parties/corporations that obtain business/professional licenses, approvals and registration. Types of violations will vary from administrative procedures, such as late

submission of report, to more serious violations such as misleading information, manipulation of financial statement, and fraudulent activities in capital market (Indonesia Capital Market Law 1995).

In relation to legal enforcement activities, the Indonesian capital market legal system adopts two types of sanctions, which are administrative sanction and criminal proceeding (article 102 – 110, Capital Market Law 1995). The administrative sanctions could be in the forms of Letter of Notice, Fines, Restriction of Activities, Freezing of Activities, Revocation of License, Cancellation of License, and Cancellation of Registration Statement Submission. IDX also has power to impose sanctions to listed companies that violated listing and trading rules, in the form of Letter of Notice, Fines and Trading Suspension. The sanctioned parties might challenge the initial imposition of administrative sanctions through subsequent appeals process. In this case, the sanctions would be referred to the initial imposition unless regulator accepts the appeals or revised its previous decision.

The criminal proceedings would be performed for any unlicensed parties/activities, unfair trading, insider trading, fraudulent reporting/activities as well as for misleading information. The agency OJK is responsible to investigate any criminal violations and prepare final investigation to the Attorney General Office (AGO). The AGO will bring further this criminal case to the Court for criminal prosecution. In conjunction with the criminal proceedings process, it should be noted that the agency's responsibility is limited to the case preparation and its case delivery to the AGO. Once a case has been handed over to the AGO, the agency has no responsibility and power to interfere or withdraw such case. In addition, the criminal sanction related to the capital market violation has not yet determined until final court decision has been made by the judge and its subsequent appeal process that could be very lengthy.

Research Methodology

The basic hypothesis for this study is that corporate governance practices are expected to prevent public company from being sanctioned by regulator. Corporate governance practices are measured using certain corporate governance attributes.

These governance attributes are the independent variables, similar to the previous studies (Beasley 1996, Chen et al. 2006, Mangena & Chamisa 2008). These attributes have been selected to reflect main attributes and specific governance condition in Indonesia, and categorized into 4 (four) main groups, which are Ownership Structure (OS), Board of Commissioners (BoC), Audit Committee (AC) and External Auditor (EA). The Ownership Structure (OS) is represented by Top Shareholder (OSTop), Number of Blockholders (OSBlock), and Ownership by Board Members (OSBoard5Percent). Boards of Commissioners (BoC) variables are measured by Board Size (OSBoardSize), Independent Member Proportion (BoCIndSize) and Board Meeting Frequency (BoCMeetFreq). Audit Committee (AC) variables are represented by Proportion of AC Member Expertise (ACExpSize) and AC Meeting Frequency (ACMeetFreq). External Auditor (EA) variable is measured by Auditor Quality (EAQual). The corporate governance attributes as independent variables are obtained from previous year before the year of incidence of sanctions happening (t-1). This approach is intended to capture the effect of corporate governance implementation that expected to prevent any incidence of sanction in the following year.

The dependent variable in this study is the Incidence of Sanctions (IOS). There is a possibility that the sanction given is not the final imposition as company could appeal against it. However, based on the current sanctions data used for the period of observation, it is

confirmed that there is no appeals process against those sanctions. As a result, this study considers all sanctions data as final impositions.

This study incorporates some control variables, which are firm size, listing age and industry. The firm size is measured in term of company total asset (AssetSize), listing age (AgeClass) is determined by the total years since initial listing in the capital market, and Industry reflects company nature of business, whether they are in financial or non financial industry.

The sample data of this study is secondary by nature because it is gathered from annual reports and financial statements of listed companies in Indonesian capital market, for the period of 2007 to 2010. The data of sanctions for listed companies, both administrative and criminal sanctions, are sourced from Bapepam-LK that documented on the website, annual report and press releases documents for the relevant period.

The corporate governance attributes and the occurrence of sanction data are collected in a sequential fashion to capture the effect of corporate governance in place before any incidence or non-incidence of sanctions. The data set is unbalanced as the study especially focuses on the sanctions occurrence and their numbers may vary from year to year.

Multivariate analysis using logistic regression model is employed to measure the relationship between corporate governance variables and the incidence of sanctions, as the incidence of sanctions is a dichotomous dependent variable.

$$\text{Ln}\,[\pi/1-\pi] = \alpha + \beta_1 \text{OSTop}_i + \beta_2 \text{OSBlock}_i + \beta_3 \text{OSBoard5Percent}_i + \beta_4 \text{BoCSize}_i + \beta_5 \text{BoCMeet}_i + \beta_6 \text{ACExp}_i + \beta_7 \text{ACMeet}_i + \beta_8 \text{EAQual}_i + \beta_9 \text{Asset}_i + \beta_{10} \text{Age}_i + \beta_{11} \text{Industry}_i$$

Data Analysis and Discussion

The total observations for the four year periods (2007 – 2010) are 1,205 observations that consist of 850 cases of non sanctioned and 355 cases of sanctioned incidences. As noted previously about the sequential collection of corporate governance variables and sanctions data, the observation periods reflect the corporate governance attributes observed in the related year, while the sanctions data are collected a year after the observed year to reflect any effects of governance implementation. The sample data is an unbalance data.

While the dependent variable is certainly a dummy variable (not sanctioned or sanctioned – 0 or 1 values), the independent variables and control variables are classified into three different scales of measurements, which are continuous, ordinal and dummy variables. For example, the OSTop variable refers to the percentage of shares owned by top shareholders (continuous scale), while the BoCMeetFreq variable is transformed into an ordinal scale of frequency of meetings, being ‘least frequent’, ‘frequent’ and ‘more frequent’ (the assigned values are 1, 2 and 3 respectively). The dummy variable type is also assigned to independent variables, for example the EAQual variable, which is 0 for non big 4 auditor or 1 for big 4 auditor quality. The approach to classify explanatory variables, especially into ordinal scale, is due to the fact that there are wide variability for certain independent variables values in the sample that considered as outliers, hence categorizing them into an ordinal scale will reduce the problem.

There are no significant correlations between independent variables, with all correlation coefficients are under 0.6 level. Therefore it proceeds with the full model of logistic regression using eViews 7 software. Running the full model with all inclusion of independent variables and control variables produces only some variables that are significant at 0.05 level. However, before taking the inferential statistic from the full model, the model fit analysis is undertaken using the – 2 log likelihood (deviance) analysis or known as LR statistic. The full model brings an improvement of the deviance (improvement here refers to a decreasing

deviance value) compare to the null model (constant coefficient model only). The full model deviance value is 1,377.33, while the null model deviance value is 1,461.00, gives an improvement of 83.67 (also referred as the LR statistic value). Hence it could be concluded that the full model provides better prediction compare to the null model.

Another approach to analyse model fit is performed using an expectation-prediction evaluation analysis (classification table). Considering 0.5 as an cut off value for successful prediction, the full model generates 71.04% of total correct prediction (predicting both sides), that consist of 96.00% correct prediction for non sanctioned cases and only 11.27% correct prediction for sanctioned cases. This full model predicts moderately the both sides of the incidences. However, the full model performs poorly to predict the incidence of being sanctioned with only 11.27% correct prediction of the expected occurrences that the study focused on.

As the full model weakly predict the occurrence of being sanctioned using 0.5 successful probability cut off, this study then introduces 0.3 successful probability cut off for the classification table analysis. The reason behind this 0.3 cut off choice is that the sample proportion of being sanctioned compare to all sample is equal to 0.29 (355/1205). This 0.3 probability cut off then is justified. Hence using 0.3 as a successful probability cut off provides the total correct prediction of both sides of 61.91%, with 62.47% correct to predict being not sanctioned and 60.56% correct to predict being sanctioned incidences. This result shows that full model adequately predict the both sides, and in particular it is fairly able to give prediction to the probability of being sanctioned, which is 60.56% correct prediction.

In addition, to further test the reliability of the full model of this study, in-sample and out-of-sample analyses are conducted. The in-sample analysis is performed using the period of 2007 until 2009 to produce in-sample model outcome. Then the model outcome is used to predict the probability of incidences (predicting the dependent variable) for the following year 2010 (out-of-sample). Then the prediction outcome is compared to the actual data/incidences the respected year. This comparison will give similar result to the classification table. Based on this approach, using 0.3 successful probability cut off, the full model generates 56.08% of total correct prediction for both sides, that consist of 56.08% correct prediction for not being sanctioned incidences and 64.19% of correct prediction of being sanctioned incidences. This 64.19% figure that resulted from in-sample and out-of-sample approach is fairly consistent with the previous result of 60.56% correct prediction of being sanctioned.

As the full model only provides some significant variables at the 0.05 level, then this study introduces the reduced model. The reduced model only considers significant variables obtained from previous full model. The reduced model also shows that all variables are significant at the 0.05 level, consistent with previous full model. However, in term of model fit analyses using LR statistic, the reduced model only produces LR statistic of 80.28, lower than the full model LR statistic of 83.67. It then concluded that the full model is better fit than the reduced model.

Therefore, after considering three previous approaches of testing the model fit and comparing to the reduced model, it could be concluded that the full model is reasonably fit for the purpose of this study. Then it proceeds to the analysis of inference statistic of the full model. The significant explanatory variables at 0.05 significant level and their sign are OSTop (-), BoCSizeClass (-), BoCMeetFreq (+), and ACMeetFreq (-), while the control variables are Asset Class (+) and Industry (-).

In the logistic regression model, the value of coefficient variables and their transformation into odds ratio are not the focal point of analysis. The transformation of each coefficient into probability of the occurrence of event (dependent variable) is the important one. However, the sign of significant coefficients still have important roles in determining the direction of relationship between explanatory variables and dependent variable.

The top shareholder variable is the only significant variables among other ownership structure characteristics and has a negative sign. It further confirms that shares ownership concentration in Indonesia is a significant factor within the area of corporate governance, as opposed to the diverse ownership situation in the anglo-saxon countries regime. This finding is in accordance with the World Bank-IMF (2010) Indonesia observance report, stated that ownership of listed companies in Indonesia remains highly concentrated. In addition, the study suggests that more ownership concentration in a single person/party, it will reduce the probability of the incidence of being sanctioned. This finding substantiates the importance of control power of top shareholder (shares concentration), to which they will be able to exercise better control over corporation to adhere rules and regulation. The negative relationship between ownership (control) and the incidence of sanctions reflects that controlling owner, with their substantial control, will maintain their good reputation through the controlled company to obey rules and regulation (minimizing sanctions).

Within the corporate governance attributes of Board of Commissioner (BoC) that served as supervisory board in Indonesia context, the size and meeting frequencies of BoC are the significant variables contributing toward the incidence of sanctions. The BoC size and BoC meeting frequencies in this study are measured using ordinal scale. The BoC size classifies as small (up to 4 members), medium (5-8 members) and large (more than 8 members), whereas BoC meeting measures frequency of board meetings in a year, that categorized as least frequent (0 – 3 times), frequent (4-12 meetings), and more frequent (>12 meetings). The finding concludes that larger BoC size will reduce the probability of incidence of sanction. It implies that more members will contribute better to the supervisory function, hence it will reduce any incidence of sanctions. However, it should be remembered that this study categorized the BoC size only into three categories, therefore adding or reducing BoC members will not have effect as long as it is still fall under the same category. Once the addition or reductions of BoC member fall into new category, then it is expected that an effect will be in place affecting the incidence of sanctions. The BoC meeting frequency variable has a positive relationship with the incidence of sanctions, so it is predicted that more BoC meeting will increase the probability of incidence of being sanctioned. This finding is contained flaw theoretically. However, in line with this conclusion, Jia et al. (2009) suggested similar conclusion in China situation, to which more frequent board meeting creates more severe enforcement actions by regulator. Further, in Indonesia situation, this finding also could be seen in the opposite direction, in which the more incidences of company being sanctioned will trigger more meeting request by BoC member to discuss the sanctions situation. Hence it is deemed that BoC function to be ineffective. Similar to BoC size variable, the BoC meeting frequency has also limited category, hence it should be analyzed cautiously when dealing with the addition or reduction of meeting frequency in a year.

In relation with audit committee attributes, the audit committee meeting frequency in a year (AC meet) is the only significant variable toward the incidence of sanctions. Again, the AC meet variable is categorized into least frequent, frequent and more frequent meeting category, with exact criteria as BoC meet variable. This study concludes that more AC meeting frequency will reduce the probability of being sanctioned. Audit committee is a BoC's subcommittee that having necessary expertise to help supervisory function of BoC, therefore

it is expected that more AC meeting should reduce the incidence of sanctions or increase the compliant to the rules and regulation. In this study, the AC meet variable is also divided into least frequent, frequent, and more frequent categories. Therefore, taking inference by changing frequency of AC meetings should consider either within or exceeding the group boundary as well.

The full model includes three control variables, asset, age and industry, and the model only produces two significant control variables at 0.05 level, which are asset and industry variables. The model concludes that bigger asset will lead to more probability of being sanctioned, while financial industry sector tend to have lower probability of incidence of sanctions compare to non financial industry. Bigger company, in term of its asset size, will have more complex situations that probably complicate to the adherence to rules and regulation. Again, the asset size variable is categorized into small, medium or large corporation, hence the changing of asset size only will have effect once the asset size exceeds to new category. In addition, financial industry sector has specific additional corporate governance rules imposed by Central Bank, hence it is expected that financial industry will perform better governance compare to non financial sector and hence increase their adherence to rules and regulation.

Conclusion

The result shows that among corporate governance attributes in Indonesia, there are only a few variables that have significant relationship to the incidence of sanctions. Top shareholder, Board of Commissioner size and meeting frequency as well as the Audit Committee meeting have significant influences toward the incidence of sanctions. The ownership structure, in particular top shareholder, has significant contribution within the model. This finding further confirms the existence of ownership concentration as reported by World Bank – IMF (2010) and support the view of agency problem between majority and minority shareholders for public corporations in Indonesia. The Board of Commissioner as supervisory board and Audit Committee as the board's organ have proved to have influence toward any incidence of sanctions, especially for board size and their meeting frequency. These results further support the importance of supervisory board and its mechanism. The meeting activity has showed that it affects the occurrence of the incidence of sanctions.

Moreover, the corporate governance model developed in this study does not produce strong significant prediction to the occurrence of any incidence of sanctions. It only contributes around 60% toward the correct prediction of the incidences. It implies that in Indonesia, corporate governance implementation has not yet promoted the effectiveness of corporate governance as advocated. Hence this study further confirms the findings by World Bank – IMF (2004 and 2010) and Financial Standard Foundation (2009) that what have been documented and its actual implementations are often distant. This situation is probably due to the strength of ownership concentration and 'ticking the box' attitude in implementing corporate governance.

The quantitative method in measuring corporate governance implementation in Indonesia is the limitation of this study. Although combination of quantitative and qualitative approach will involve considerable amount of time and efforts, it is worth to consider in assessing the substance over forms of corporate governance. Thus future research should extend the study using combination of quantitative and qualitative method and may introduce other measure of corporate governance effectiveness.

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