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## **What Effects Do Privatisation Policies Have on Corporate Governance of State-Owned Enterprises?**

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**Abstract:**

*This study attempts to test the effect of state ownership and follow-up of audit findings in state-owned enterprises (SOEs) owned by the government of the Republic of Indonesia, on the good corporate governance of SOEs.*

*By using Ordinary Least Square (OLS) analysis, conducted by observing 98 observations during 2010-2014, the findings show that there are negative relationship between state ownership and good corporate governance implementation in SOEs in Indonesia.*

*In addition, the results also reveal that the follow-up of audit findings positively affect the implementation of governance.*

**Keywords:** *Good Corporate Governance, State ownership, privatization, audit findings, State-Owned Enterprises (SOEs)*

**JEL Classification:** *G31, G34, G38, L33, M42*

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## 1. Introduction

The performance of state enterprises in Indonesia generally has not provided an optimum contribution to the national economic growth and government annual revenue, primarily caused by the inadequacy of the implementation of Good Corporate Governance (GCG). Basically, Good Corporate Governance (GCG) is considered not only as a formality, but also as a system which is able to influence the value of company. The impetus for good corporate governance is very demanded for many Southeast Asian countries that experience overwhelmingly monetary crisis in the late 1990s, caused mainly by a weak implementation of corporate governance in public sector, monetary institutions and private companies. A research conducted by the Asian Development Bank (ADB) identifies that the lack of corporate governance, particularly in Indonesia, was the main contributors of that crisis (Zhuang, De Dios, and Martin, 2000).

Unlike previous studies arguably focusing more on the implementation of Good Corporate Governance as a means to improve the performance of private business (Chiang He & Lai, 2012; Colarossi *et al.*, 2008) and government-owned enterprises, especially in developing countries (Colley *et al.* 2003; Zeitun, 2009; Babatunde & Olaniran, 2009), this study aims to analyze the effect of state ownership and the follow-up of the results of financial investigation on the implementation of GCG of State-Owned Enterprises in Indonesia. This study basically aims to provide the broader scope of analysis from previous study of Munawarah *et al.*, (2017), by examining the role of follow-up of audit findings on the GCG practice in SOEs. Thus, there are two contributions of this study compared to previous studies, that are the need for privatization in enhancing the credibility of business management of SOEs; and the role of follow-up of audit findings in improving the effectiveness of corporate governance.

## 2. Literature Review and Hypothesis Development

The Organization of Economic Cooperation and Development (2005) states that SOEs are an important part of gross domestic product, employment and market capitalization of a country, especially with the acquisition of such strategic industrial infrastructure as energy, transportation and telecommunications. Moreover, the performance of SOEs has a broader segmentation as they can affect other business sectors. The development of an increasingly competitive global market, a more rapid technological advance and the deregulation of monopolistic markets have by far become the fundamental needs of the adjustments and restructuring of SOEs, including their privatization by stock offerings in the capital markets.

Claessens *et al.* (2002) showed that the state as the controller is very concerned to increase the value of state-owned companies by exploiting SOEs to generate large dividend to increase the state revenue. On the other hand, a very large controlling right by the state will also be able to lead to further decline in the company value and

the potential occurrence of the expropriation of the minority shareholders. Therefore, it is necessary, regarding the existence of GCG as a set of rules, to regulate the activity of SOEs management to ensure the ongoing creation of the general welfare. In addition, GCG is expected to avoid a gap between the principal and the agent of government roles. Therefore, the implementation of Good Corporate Governance is highly demanded to limit the government roles and political interference, and to regulate the state ownership to create a common interest as stipulated in the basic guidelines for the implementation of GCG of SOEs (OECD, 2005; Ivanova and Bikeeva, 2016).

In addition, as a basic means to protect the right of minority shareholders from mastery or appropriation of rights by managers and government as the controlling shareholder of SOEs, GCG practice is perceived to be able to minimize any opportunistic behaviour (Mitton, 2002; Savina, 2016; Menshchikova and Sayapin, 2016; Baldacchino *et al.*, 2017; Toudas and Bellas, 2014; El-Chaarani, 2017). The application of GCG in SOEs could reduce any behaviour possibly arising from government ownership. This, in turn, can help increase the company's performance and value.

Moreover, the role of the legislative council as a watchdog over financial management and the performance of SOEs is needed to create an effective implementation of Good Corporate Governance. Kusumawardhani (2012) finds a positive influence of legislative oversight, as measured by the number of parliament members in the Board of Commissioners, on the financial performance of local government. It means that a greater number of legislature will lead to a more effective supervisory function, that eventually results in a higher government financial performance.

*H1: State ownership has negative effect on the implementation of Good Corporate Governance.*

Auditing is one of the institutional responsibilities of both public and private businesses concerned mainly for pointing out the errors in financial account. The result of the audit findings will be very helpful in creating accountability in financial management (Setyaningrum *et al.*, 2014; Pociovalisteanu and Thalassinou, 2008; Giannakopoulou *et al.*, 2016). For managers of state finances, partially in Indonesia, the obligation to follow up the result of the audit report, as stipulated in Law No. 15/2004, is the responsibility of the entity or auditee. In fact, however, from 2008 until 2012 only few recommendations (55%) of the report were followed up in accordance with the recommendations of the bureau, while the remaining of 45% was followed up not in accordance with the recommendations, that were eventually put in the category of non-actionable (IHPS BPK RI, 2013).

Lin and Liu (2012) state that although the detection of irregularities is an important part of auditing, it is just the first step before others which are more important,

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namely asking responsibility and making corrections. Therefore, high-quality auditors are expected to be able to generate appropriate recommendations which are relatively easily implemented in accordance with the company conditions. This, in turn, leads to a higher and more effective follow-up of audit recommendations.

Claessens and Yurtoglu (2012) find that the level of state ownership and the diversity of corporate governance applied in each country are influenced by the economic diversity and financial conditions, institutional environment and structures, and group affiliates and investors. Bhagat and Bolton (2008) find that the SOEs performance is influenced by corporate governance, capital structure and ownership structure. Xu and Wang (1999), Qiang (2003), Ang and Ding (2006) reveal that the SOEs governance structure is strongly influenced by the level of state ownership.

Hence, although the ownership structure of a country is perceived to be able to have a direct impact on performance, there is a role of corporate governance in mediating this effect. Nguyen and Van Dijk (2012) demonstrate that the corporate governance of SOEs may reduce the level of corruption and negatively impact on corruption. Hence, the audit findings have an important role in highlighting the potential cases of corruption and mismanagement in the SOEs. Thus, the process of auditing is likely to be able to improve the good corporate governance of SOEs. This means that the auditing results are an effective means for the implementation of good corporate governance.

Efendy (2010) notes that the audit recommendations should be followed by any related institutions to keep auditor motivation in pointing the fraud that occur. Improving the effectiveness of the recommendation is one of the strategic objectives apparently outlined in the business performance indicators. For auditors, audit finding recommendations and implementations determine the effectiveness of their functions and roles to encourage the quality of public sector management and state finance (Setyaningrum *et al.*, 2014). Additionally, Rongbing and Yuetang (2010) argue that the correction or improvement efforts made by the audit institutions and associated parties in China related to the findings are the most important factors in determining the extent to which auditing bodies can perform transparency and promote accountability of the public sector and private company.

*H2: There is a positive relationship between the follow-up of auditing findings and implementation of Good Corporate Governance.*

### **3. Methodology**

#### ***3.1 Sampling Method***

This study was conducted by observing the data from the period 2010-2014, by using purposive judgment sampling method. The SOEs were selected as sample based on several requirements. Among them, the companies must have the data on

the number of auditing report follow-up during the observation period, and were listed the value of the evaluation assessment on the application of GCG based on the Decree of the Ministry of State Enterprises No.SK-16/S.MBU/2012 or the Circular of the Ministry of State Enterprises No.S-168/MBU/2008. Moreover, the companies must have proprietary data of government and non-government ownership share on enterprises, and have a complete data related to all variables examined during the observation period.

After several selection processes, the amount of sample was 98 SOEs, consisted of 28 observations of public companies and 70 observations of unpublic companies. Among them, 17 companies was taken from 2010 data, 23 from 2011, 22 from 2012, 27 from 2013, and 9 from 2014. Majority of sample was from transportation and warehousing industry with 32 observations (32.65%), followed by finance and insurance with 16 observations (16.33%), mining with 16 observations (12.24%), and manufacture with 10 observations (10.20%).

*Empirical Model and Measurement of Variables*

To assess the proposed model, the following formula of ordinary least-square was used:

$$GCG_{it} = \beta_0 + \beta_1 GOV_{it} + \beta_2 AUD + \varepsilon_1 \quad (1)$$

in which the GCG is good corporate governance measured by the scores on the assessment of GCG implementation based on the regulation of the Minister of SOEs, on the assessment conducted by either the state or independent parties. The assessment of the implementation of GCG after 2012 used appropriate parameters as specified by the Letter of Secretary of the Ministry of SOEs No.SK-16/S.MBU/2012 on the indicators and parameters of Assessment and Evaluation of the Implementation of GCG in SOEs. As for the year 2011 and earlier, this study used the Circular Letter of the Ministry of SOEs No.S-168/MBU/2008 on the Implementation of GCG Practices in SOEs (Munawarah et al, 2017: 956); AUD, is the follow-up of the recommendations of the bureau, as measured by the percentage of the number of those having actually been implemented by the particular enterprise in accordance with the recommendation of the bureau compared to the total number of bureau recommendations; GOV is the government ownership in SOEs, as measured by the percentage of government ownership as compared to the total stocks.

## **4. Results**

### ***4.1 Descriptive Statistics***

The results of descriptive statistics reveal that privatized SOEs have a higher mean value in all the variables of the audit findings and corporate governance than those in non-privatized ones. This indicates that the bureau recommendation and GCG assessment scores for the publicly listed SOEs are higher.

**Table 2.** *Statistic Description of Variables*

Items	Mean	Median	Std. Dev	Min	Max
Panel A: Overall Sample = 98 Observations (firm-year)					
AUD	43.568	41.24	40.602	0	100
GOV	89.688	100	16.174	51	100
IDX	0.285	0	0.454	0	1
GCG	83.490	83.58	7.167	66.56	96.32
Panel B: Privatized SOEs= 28 Observations (firm-year)					
AUD	56.893	66.186	42.213	0	100
GOV	65.76	65.01	8.554	51	85.81
GCG	87.169	86.725	5.919	75.68	96.32
Panel C: Unlisted SOEs = 70 Observations (firm-year)					
AUD	38.238	25.343	38.979	0	100
GOV	99.26	100	3.725	73.15	100
GCG	82.018	82.1	7.128	66.559	94.62

*Source:* data processed, 2016.

**Table 3.** *Test for Equality of means of AUD and GCG categorized by values of IDX*

Variable	Df	Value	Probability
AUD (Anova F-test)	41.24	40.602	100
GCG (Anova F-test)	100	16.174	100

*Source:* data processed, 2016.

#### 4.2 Hypothesis Testing

H1 states that there is the effect of state ownership on the SOEs' corporate governance, while H2 states the effect of follow-up of audit findings on SOEs' corporate governance. The results show the effect of state ownership (GOV) and the follow-up of auditing reports (AUD) on the implementation of Good Corporate Governance (GCG). Overall, the independent variable of GCG can explain the variation by 18.53% percent. The results also reveal that the state ownership has a significant negative effect on the GCG with a negative coefficient of  $-0.0125$  at a significance level of 5 percent. This result indicates that hypothesis 1 is accepted, meaning that an increase of state ownership in SOEs can decrease state ownership negatively of GCG implementation.

The testing also finds that the variable of following up the auditing results has a positive and significant influence on the implementation of GCG with a coefficient of  $0.049$  at a significance level of 5 percent. This means that the higher the following up of the auditing results, the higher the effectiveness of the implementation of GCG in SOEs. Thus, hypothesis 2 is accepted.

**Table 4.** *Hypothesis Testing*

Variable	Coefficient	Std. Error	t-statistic	Prob.
Constant	92.52061	4.001767	23.11994	0.0000

GOV	-0.124511	0.041773	-2.980671	0.0037
AUD	0.049041	0.016640	2.947144	0.0040
R-square	0.185328			
Adjusted R-square	0.168177			
F-statistic	10.80564			
Prob. (F-statistic)	0.000059			
AUD, is the number of follow up on the recommendations of the audit findings of the bureau, measured by the percentage of the number of follow-up recommendations that has been implemented by the state in accordance with the recommendation of the bureau compared to the total number of the recommendations. GOV, is the government shareholding in SOEs, measured by the percentage of government ownership as compared to total stock. GCG, is good corporate governance, measured by scores on the assessment of GCG implementation based on the regulation of Minister of SOEs, either on its own assessment conducted by state-owned or assessment by independent parties.				

*Source: data processed, 2016.*

The testing results show that state ownership influence SOEs' governance. This result is consistent with the studies of Munawarah et al. (2017), Xu and Wang (1999), Qiang (2003), Bhagat and Bolton (2008), Nguyen and Van Dijk (2012). Lisic *et al.* (2014) state that Chinese company largely owned by the state negatively affects the fraud occur at the company. Moreover, the findings of Wahyuni (2011) show that government ownership negatively affects the SOEs performance in Indonesia.

## 5. Conclusion

The results show that the state ownership has negative effect on corporate governance in SOEs. This means that a lower level of corporate governance is likely to lead to an increased audit findings. The result also shows that the follow-up of recommendations of the bureau positively affects the implementation of Good Corporate Governance, highlighting the importance of following up the recommendations of the bureau to advance the effectiveness of the implementation of GCG. Moreover, the findings reveal that publicly listed SOEs have better auditing result and higher implementation of GCG, significantly different with the non-listed enterprises. The conclusions generally imply to reduce the potential audit findings from the bureau and to reduce the level of state ownership by privatization strategies.

This study also has some limitations. Even though the number of sample was achieved in accordance with the criteria proposed, it was still relatively small as it used only few number of Indonesia's SOEs listed in the IDX. In addition, the model has not considered the opportunistic behaviour describing several characteristics of the company management and other variables that can be considered as control variables. Hence, these two considerations can be examined in further researches.

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