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## **The Role of Corporate Governance on the Effect of State Ownership on Audit Findings at State-Owned Enterprises**

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A.C. Furqan, M.I. Abdullah, M. Iqbal, R. Masdar<sup>1</sup>

**Abstract:**

*This study aims to analyze the extent to which the mediating role of corporate governance on the influence of state ownership on audit findings issued by Audit Board of the Republic of Indonesia on State-Owned Enterprises in Indonesia.*

*The study used a sample of 98 observations (firm-year) during the period of 2010-2014. The results indicate that directly in line with predictions, there is a positive influence of the degree of state ownership on audit findings, and it is found that the level of state ownership has an indirect and negative effect on the governance of state enterprises, resulting in a negative impact of corporate governance on the audit.*

*The results of this study imply that in order to reduce the potential for audit findings, the steps that need to be taken by the government gradually are to reduce the state ownership portion of SOEs, especially by privatization through stock offerings on the capital market and encouraging the implementation good governance in SOEs.*

**Keywords:** *Corporate governance, state ownership, privatization, audit finding, state-owned enterprises (SOEs).*

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<sup>1</sup>*Universitas Tadulako, e-mail:*

## 1. Introduction

This study aims to analyze the extent to which the corporate governance is capable of mediating the influence of state ownership on audit findings on SOEs in Indonesia. The main focus of this research is to assess the mediating role of corporate governance in explaining the effect of state ownership or privatization on the performance of SOEs, particularly audit findings that are still lacking in the previous literature. Previous studies have more focused on direct effect of privatization on SOE performance. Although many parties agree that privatization has a positive impact on the performance of SOEs, but there are still some who highlight that empirically it has not been fundamentally proven (Aivazian *et al.*, 2005; Tsamenyi *et al.*, 2010). Bhagat and Bolton (2008) examining the relationship between performance, corporate governance, ownership structure and capital structure found that performance is influenced by corporate governance, which thereby influencing both capital structure and ownership structure (Giannakopoulou *et al.*, 2016).

Xu and Wang (1999), Qiang (2003) and Ang and Ding (2006) found that corporate governance structures are strongly influenced by state ownership levels in SOEs. It is worthwhile to note that although the state ownership structure has a direct effect on performance, the role of corporate governance structures in mediating that influence is inevitable. Specifically, in terms of the relationship between corporate governance of SOEs on audit findings, Nguyen and Van Dijk (2012) found that SOEs corporate governance can reduce the level of corruption and negative impact on corruption. Accordingly, the corporate governance applied by SOEs can negatively affect the audit findings. There are at least three contributions to this study compared to previous studies. First is the attempt to examine the role of corporate governance in mediating the influence of state ownership on audit findings issued by Audit Board of the Republic of Indonesia (BPK). Second, it provides additional empirical evidence of the need for privatization in improving the credibility of business management and simultaneously improving corporate governance. Thus, the procedural errors, irregularities or fraud that lead to large audit findings in the management of SOEs can be minimized.

## 2. Literature Review and Hypothesis

The issue of ownership is particularly important. Fama and Jensen (1983) argue that the separation of ownership and control in complex organizations can lead to an increasing number of agency issues along with the separation of decision-making by management and risk coverage to the public (Kurniawan, 2017). In large companies, for example public companies, residual claims on common stocks have no restrictions, because shareholders are not required to have other roles in the organization. Thus, risk is not limited among shareholders, which can lead to greater opportunistic management. In terms of the influence of government ownership in SOEs' Claessens *et al.* (2002) indicates that as a controller, the state is very

concerned to increase the value of state-owned enterprises, which can be driven by the desire to earn a large dividend in order to support the increase of state revenues. However, on the other hand a very large control by the state will also result in declining corporate value and the potential for expropriation of minority shareholders (Munawarah *et al.*, 2017; Siallagan *et al.*, 2017). Associated with the theory of legitimacy, especially in the public sector, organizational legitimacy is generally described as a condition of organizational behavior that is in line with expectations of the parties around the organization running its activities (Suchman, 1995).

Therefore, the nonconformity or failure of the organization in performing its functions and responsibilities will likely pose a serious risk to the organizational legitimacy. The risks will be aggravated by the growing demands on the transparency and accountability of organizations (Power, 2003; Din *et al.*, 2017). This, when the legitimacy of the organization becomes diminished, will potentially diminish the flow of resources received and adversely affect the achievement of organizational goals. Therefore, it is important for organizations to design and manage organizational institutions in order to protect or maintain legitimacy (Gabrini, 2013). Therefore, in addition to opportunistic behaviors that can underlie government ownership in the management of SOEs which then leads to appropriation, government ownership in SOEs can also serve as a tool to demonstrate the government's performance in order to mobilize legitimacy from the public. Ang and Ding (2006) state that this such condition is likely able to stimuli the influence, either positive or negative, of ownership on the audit findings. Accordingly, this study proposes the hypothesis as follows:

*H1. Government ownership affects audit findings.*

In the context of the relationship between corporate governance and audit findings, Hermawan and Adinda (2012), Fujianti (2018) have proved that the existence of independent commissioners as the most important element in the application of GCG has a positive effect on improving the quality of profit. The existence of independent commissioner can reduce the existence of accrual discretion or management earnings that can reduce the quality of earnings (Wibowo and Ghazali, 2018). Therefore, their presence in GCG system is expected to be able to supervise and control the management in order to always perform the company's management according to the standards and comply with the applicable regulations. This ultimately will likely be able to reduce negative audit findings and also improve assurance in improving or following up on audit findings (Din *et al.*, 2017).

Bhagat and Bolton (2008) found that good governance which is influenced by capital structure and ownership structure will affect company performance. In addition, opportunistic behavior of controlling and management shareholders can be minimized by the application of good GCG practices. This is happened because GCG is a means of protecting minority shareholders from the control or appropriation of rights by either managers or controlling shareholders (Mitton,

2002). Therefore, the application of GCG to SOEs can reduce opportunistic behavior that may arise from government ownership and vice versa, can help improve the performance and value of companies pursued by the government as the controlling shareholder of SOEs. The hypothesis is as follows:

*H2. There is an indirect effect of government ownership on audit findings through the application of good governance.*

### 3. Research Methods

This study uses the samples of Indonesian SOEs during the period 2010-2014, based on the list of SOEs under the guidance of the Ministry of SOEs. The sample selection was conducted using purposive judgment sampling method, with the following criteria. First, the SOEs have data on audit findings on inspection conducted by BPK during the observation period. Second, the SOEs include evaluation result on GCG implementation based on Decree of Secretary of Minister of SOE No. SK-16/S.MBU/2012 or Circular Letter of State Ministry of SOE No. S-168/MBU/2008. Third, the sample have complete data related to all research variables studied during the observation period.

**Table 1: Overview of Research Sample**

<b>Panel A (sample determination)</b>	<b>Observation (firm-year)</b>	<b>Number of SOES</b>
SOES data under Ministry of SOEs (2010-2014)	<b>585</b>	<b>117</b>
Do not have audit finding report	(441)	-
Do not include GCG scores on annual reports	(46)	-
Number of Final Samples	<b>98</b>	<b>51</b>
<b>Panel B (Sample Description)</b>	<b>Observation (firm-year)</b>	<b>Percent (%)</b>
<b>By Industry</b>		
Manufacturing industry	10	10.20
Financial Services and Insurance	16	16.33
Professional, scientific and technical services	4	4.08
Construction	8	8.16
Water supply, waste management and recycling	1	1.02
Procurement of electricity, gas, steam / hot water and cold air	7	7.14
Trade, repair and maintenance of cars and motorcycles	2	2.04
Mining and excavation	12	12.24
Agriculture, forestry and fisheries	4	4.08
Real estate	2	2.04
Transportation and warehousing	32	32.65
<b>Final samples by industry</b>	<b>98</b>	<b>100</b>
<b>By year</b>		
2010	17	17.35
2011	23	23.47

2012	22	22.45
2013	27	27.55
2014	9	9.18
<b>The final sample by year</b>	<b>98</b>	<b>100</b>
<b>Based on Privatization (Go Public)</b>		
Go Public	<b>28</b>	
Non Go Public	70	
<b>The final sample Based on Privatization (Go Public)</b>	<b>98</b>	<b>100</b>

Based on the criteria for determining the samples, a final sample of 98 firm-year observations from 51 SOEs is shown in table 1 panel A. Panel B shows that the entire final sample represents 11 industries, in which industrial transportation and warehousing sector has the largest number of 32 observations (firm-year) or 32.65% of the overall sample. Based on observation year, it is showed that 2014 only has 9 observations or 9.18% and for 2010 until 2014 the number of samples is in the range of 17-27 observations. The number of samples based on privatization (go public) categorization shows that as many as 28 observations were classified as privatized SOEs and 70 observations were categorized as closed companies.

To answer the problem of research and simultaneously test the hypothesis, hence, empirical equation model was used simultaneously with two stage least square:

AUD is the audit findings measured by the number of audit findings on the examinations conducted by BPK on SOEs. GOV is government ownership of shares in state-owned enterprises as measured by percentage of government share ownership compared to total shares. GCG is Good Corporate Governance, as measured by GCG implementation score on SOEs based on SOE Minister regulations, either on self-assessment by SOES or independent valuation result appraisal of GCG implementation on SOE using parameter according to Letter of Secretary of Minister of SOE No.SK-16/S.MBU/012 on indicators/parameters assessment and evaluation of GCG implementation on SOEs. Until the year 2011, the assesment used the Circular Letter of State Ministry of SOEs No. S-168/MBU/2008 on the Implementation of GCG Practices in SOEs. LnASSET as control variable, refers to the total of SOE assets as measured by Logarithm Natural of total assets owned by SOEs.

#### **4. Results and Discussion**

The descriptive statistics provides an overview of the samples used in the study by describing mean, median, standard deviation, min and max of each variable studied. Based on the sample of research which amounted to 98 observations, it is obtained description of the variables as presented in Table 2.

**Table 2: Description of Variable Statistics**

Information	Mean	Median	Std. Dev	Min	Max
<b>Panel A: Sample Overall = 98 Observations (firm-year)</b>					
AUD	19.112	14	18.667	1	129
FUAUD	43.568	41.245	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
ASSET	72,759.25	8,436.92	166,860.55	238.81	733,099.76
<b>Panel B: Privatized SOEs = 28 Observations (firm-year)</b>					
AUD	15.428	13.5	10.300	2	48
FUAUD	56.893	66.185	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
ASSET	67,485.12	14,433.63	157,949.4	733,958	733,099.8
<b>Panel C: Not Privatized SOEs = 70 Observations (firm-year)</b>					
AUD	20.585	14	20.991	1	129
FUAUD	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
ASSET	74,868.90	6,094.90	171,355.63	238.81	626,0079.33
<p><i>AUD</i> is an audit of the AUDIT BOARD as measured by the number of audit findings on audits by AUDIT BOARD on SOEs. <i>FUAUD</i> is a follow up on the BPK recommendation as measured by the percentage of total follow-up that has been carried out by SOEs in accordance with the BPK recommendation compared to the total number of BPK's recommendations. <i>GOV</i> is the government's shareholding in SOEs as measured by the percentage of government share ownership compared to the total shares. <i>IDX</i>, is a privatization done on SOEs as measured by dummy, that is the value "1" for privatized SOEs and "0" for non-go public SOEs. <i>GCG</i> is Good Corporate Governance, as measured by GCG implementation score on SOEs based on SOE Minister regulation, either on self-assessment by SOEs or independent assessment result. <i>ASSET</i> is the total value of assets measured by the absolute value of total assets in billions rupiah.</p>					

Table 2 panel A presents the variables of the overall sample, while panel B and panel C presents a sample of privatized SOEs as many as 28 firm-year observations and non-privatized as much as 70 firm-year observations of the entire sample. It can be seen that the comparison of privatized SOEs and non-go public SOEs, from all variables the variables of follow-up of audit findings and GCG on privatized SOEs have a higher mean value compared to SOEs that are not in privatization. For variables of audit findings and assets, the mean value held by the un-privatized SOEs is higher than the mean value of the variables owned by the privatized SOEs. This indicates that follow-up on the recommendation of BPK's audit findings and GCG score for privatized SOEs is better than those of un-privatized SOEs. On the other hand, the findings of audit and total assets owned by SOEs that do not go public are higher than those of privatized SOEs.

**Table 3: Variable Correlation Analysis**

Variable	AUD	FUAUD	GOV	GCG	IDX	LnASSET
<b>AUD</b>	1.000					
<b>FUAUD</b>	0.076 (0.455)	1.000				
<b>GOV</b>	0.136 (0.181)	-0.187* (0.065)	1.000			
<b>GCG</b>	-0.206** (0.041)	0.330*** (0.001)	-0.332*** (0.001)	1.000		
<b>IDX</b>	-0.125 (0.218)	0.208** (0.039)	-0.940*** (0.000)	0.326*** (0.001)	1.000	
<b>LnASS</b>	0.576*** (0.000)	0.064 (0.526)	-0.0175* (0.084)	0.342*** (0.000)	0.171* (0.091)	1.000
<b>ET</b>						

*AUD is an audit of the AUDIT BOARD as measured by the number of audit findings on audits by AUDIT BOARD on SOEs. FUAUD is a follow up on the BPK recommendation as measured by the percentage of total follow-up that has been carried out by SOEs in accordance with the BPK recommendation compared to the total number of BPK's recommendations. GOV is the government's shareholding in SOEs as measured by the percentage of government share ownership compared to the total shares. IDX, is a privatization done on SOEs as measured by dummy, that is the value "1" for privatized SOEs and "0" for non-go public SOEs. GCG is Good Corporate Governance, as measured by GCG implementation score on SOEs based on SOE Minister regulation, either on self-assessment by SOEs or independent assessment result. LnASSET is the total SOE asset, as measured by logarithm natural of total assets owned by SOEs.*

\* \*\*, \*\*, \* = P-value significant 1%, 5%, 10%.

The first Hypothesis predicts that there is a direct influence of state ownership on audit findings, whereas hypothesis two states that there is an indirect influence of state ownership on the audit findings of SOEs through the mediating role of corporate governance. Table 4 provides an overview of the results of tests on H1 and H2. The results show that the model used to examine the direct influence of state ownership (GOV) on audit findings (AUD) can explain the variation of audit findings by 12.51 percent and significant at 1 percent level. In the test results of this model, it can be seen that the direct ownership of the state have a positive and significant impact on audit findings with a coefficient of 0.312 at a significance level of 5 percent. These results indicate that the data used in this study is in accordance with the acceptance of first hypothesis. This means that an increase in state ownership of SOEs by 1 percent is more likely to affect the increase of audit findings of 0.312.

In addition, it is also found that the assets of SOEs as a control variable has a positive and significant impact on audit findings with a coefficient of 5.815 at the level of significance of 5 percent. This means that an increase in assets in SOEs by 1

percent will more likely be able to affect the increase of audit findings of 5.815. In other words, the higher the asset of SOEs, the higher the audit findings range. Moreover, the test results on GCG variable in this model did not show any significant effect on audit findings.

**Table 4:** Hypothesis Testing Results

Variable	Sign	Direct Influence (AUD)	Indirect Influence	
			GCG	AUD
<b>Intercept</b>	( ? )	-123.494** (0.037)	76.795*** (0.000)	69.112 (0.223)
<b>GOV</b>	( ? )	0.312** (0.035)	-0.124*** (0.001)	-
<b>GCG</b>	( - )	0.245 (0.396)	-	-2.262** (0.034)
<b>LnAsset</b>	( ? )	5.815*** (0.002)	1.106*** (0.000)	8.589*** (0.001)
<b>N</b>		98	98	98
Prob. > F / chi <sup>2</sup>		0.005***	0.000***	0.002***
Adj. R-Squared		-	17.72	-
Wald Chi2		12.51	-	11.75

AUD is an audit of the AUDIT BOARD as measured by the number of audit findings on audits by AUDIT BOARD on SOEs. FUAUD is a follow up on the BPK recommendation as measured by the percentage of total follow-up that has been carried out by SOEs in accordance with the BPK recommendation compared to the total number of BPK's recommendations. GOV is the government's shareholding in SOEs as measured by the percentage of government share ownership compared to the total shares. IDX, is a privatization done on SOEs as measured by dummy, that is the value "1" for privatized SOEs and "0" for non-go public SOEs. GCG is Good Corporate Governance, as measured by GCG implementation score on SOEs based on SOE Minister regulation, either on self-assessment by SOEs or independent assessment result. LnASSET is the total SOE asset, as measured by logarithm natural of total assets owned by SOEs.  
\* \*\*, \*\*\*, \* = P-value significant 1%, 5%, 10%.

To assess the indirect influence of corporate governance, table 4 shows that by controlling state-owned assets, state ownership negatively affects GGC, with a significant coefficient of -0.124 at 1 percent level. Furthermore, GCG also has a negative effect on audit findings with negative coefficient of -0.124 and significant at 5 percent. Accordingly, an increase of state ownership of SOEs by 1 percent is potential to decrease GCG score equal to 0.124, and a decrease of 1 in GCG score will more likely be able to increase of audit findings 2.262 basis point. This result, henceforth, corresponds to that predicted on H2 stating that there is an indirect influence of state ownership on the audit findings of SOEs through the mediating role of corporate governance.

The results of this study support Xu and Wang (1999) and Qiang (2003) stating that corporate governance in SOEs is heavily influenced by state ownership. In this such

context, large state ownership can reduce the quality of governance practices in SOEs, and thus by improving corporate governance of SOEs should be initiated by reducing the government's involvement and ownership in SOEs. In addition, in general this study is also consistent with the results of Bhagat and Bolton's (2008) research which found that corporate governance affects the company's performance. More specifically it supports the findings of Nguyen and Van Dijk (2012) which concluded that the corporate governance can reduce the level of corruption occurring in state-owned enterprises and the negative impact of corruption on corporate growth.

Therefore, although the BPK's audit findings do not fully describe the fraud that occurred in the company, at least the results of this study is able to provide different perspective from Lisic *et al.* (2014) who found that most state-owned enterprises in China had a negative effect on the fraud that occurred in the company. Basically, the findings of this study supports Wahyuni's findings (2011) which shows that government ownership negatively affects the performance of SOEs in Indonesia. Thus, to reduce the risk of government appropriation efforts, opportunistic management or any possibility that causes increasing audit findings, it is necessary to start by reducing the level of state ownership of SOEs. The study of Munawarah *et al.* (2017) also confirms that the level of state ownership has a negative effect on the implementation of governance. With the reduced state ownership, it will automatically become a trigger for SOEs to further improve the implementation of good corporate governance. The implementation of good governance in SOEs furthermore will enhance the SOE management activities to be more professional, appropriate and in accordance with the applicable rules.

## **5. Sensitivity Tests between State Ownership and Privatization**

There are at least 3 methods of privatization, namely directly offered to investors, to management and or employees and to the public through the capital market. In the Indonesian context, the main method used is through the public offering of shares in the stock market (go public in Indonesia Stock Exchange/IDX). This is expected to further encourage the implementation of good governance. In addition, Megginson *et al.* (2004) found that privatization options were influenced by the political, institutional and economic factors of a country with some of the objectives of privatization being to increase government revenues, reduce government intervention, as a strategy to develop the capital market, to increase efficiency, improve the ability of SOEs to compete and increase the compliance of SOEs in carrying out regulations, particularly related to regulations on the capital market. To examine the effectiveness of such privatization and as a sensitivity test on the measurement of state ownership variable, in addition to using the measurement of percentage of state ownership (GOV), the test of state ownership is also measured by dummy variable (IDX), in distinguishing between public and non-go public companies. Table 5 shows that the model used to test the direct influence of state ownership (IDX) on audit findings (AUD) can explain variations in audit findings

by 13.09 percent and significant at 10 percent level. In the test results, it is seen that directly, privatized SOEs have a lower (negative) audit findings of 10.497 compared with non-public SOEs and the difference is significant at the level of 5 percent.

**Table 5:** Sensitivity Test Results of State Ownership on SOEs with Privatization Through Capital Market

<b>Variable</b>	<b>Sign</b>	<b>Direct Influence (AUD)</b>	<b>Indirect Influence</b>	
			<b>GCG</b>	<b>AUD</b>
<b>Intercept</b>	( ? )	-90.794** (0.045)	64.236*** (0.000)	64.167 (0.265)
<b>IDX</b>	( - )	-10.497* (0.050)	4.351*** (0.002)	-
<b>GCG</b>	( - )	0.229 (0.425)	-	-2.183** (0.042)
<b>LnAsset</b>	( ? )	5.800*** (0.002)	1.114*** (0.000)	8.487 (0.001)
<b>N</b>		98	98	98
<b>Prob. &gt; F / chi<sup>2</sup></b>		0.004***	0.000***	0.002***
<b>Adj. R-Square</b>		-	17.41	-
<b>Wald Chi2</b>		13.09	-	11.92

AUD, is an audit of the AUDIT BOARD as measured by the number of audit findings on audits by AUDIT BOARD on SOES. FUAUD, is a follow up on the Audit Board's recommendation as measured by the percentage of total follow-up that has been carried out by SOES in accordance with the Audit Board recommendation compared to the total number of Audit Board's recommendations. GOV, is the Government's shareholding in SOES as measured by the percentage of government share ownership compared to the total shares. IDX, is a Privatization done on SOES as measured by dummy, the value "1" for SOES goes public and "0" for non-go public SOES. GCG, is Good Corporate Governance, as measured by GCG implementation score score on SOES based on SOES Minister regulation, either on self-assessment by SOES or independent assessment result. LnASET, is the total SOES asset, as measured by Logarithm Natural Total Assets owned by SOES.  
\* \*\*, \*\*, \* = P-value significant 1%, 5%, 10%.

Furthermore, Table 5 shows that publicly owned SOEs have higher GGC scores of 4.351 compared to GCG scores on non-public SOEs, and significant at 1 percent level. With the higher GCG, the audit findings on privatized SOEs were lower by 2.183 compared with audit findings on non-go public SOEs, where the GCG score difference and audit findings were significant at 1 percent and 5 percent respectively. The sensitivity test results show that while using different state ownership measures, there is no difference with the previous test results. This means that the research models developed in this study are robust in explaining the important role of corporate governance as a mediating variable on the effect of state ownership on audit findings.

## **6. Conclusion**

This study used a sample of 98 observations (firm-year) during the period of 2010-2014 aiming at analyzing the role of corporate governance on the influence of state ownership on audit findings of SOEs in Indonesia. The results shows that there is a direct positive influence of the level of state ownership on audit findings. This result is robust when tested by distinguishing between the sample of SOEs that have been privatized and unprivatized SOEs. Specifically, go public SOEs have lower audit findings compared to non-public SOEs. Meanwhile, using the simultaneous two stage least square testing in analyzing the indirect influence of state ownership on audit findings, it is found that the level of state ownership has a negative effect on the governance of state enterprises.

Furthermore, this causes a negative effect between corporate governance and audit findings. Such results may provide additional explanation for the positive influence of state ownership on audit findings, ie when state ownership is dominant in a SOE, it can reduce the quality of good governance practices. The poor corporate governance in SOEs can lead to increased audit findings on the SOE. These results are also robust for two measurements of government ownership in SOEs, using variables of government ownership and privatization. In general, the conclusion of this study implies that in order to reduce the potential for audit findings, some steps that need to be taken by the government in stages are to reduce the state ownership of state-owned enterprises, especially by privatization through stock offerings in the capital market and to encourage the implementation of good governance in SOEs.

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