CHAPTER II

LITERATURE REVIEW

2.0 Introduction

This chapter provides a comprehensive overview of the theoretical underpinnings that guide this study. It begins by discussing the relevant theories that explain the relationship between corporate governance, risk disclosure, and financial performance. Following this, a conceptual framework is presented to illustrate these relationships. The chapter concludes with the development of hypotheses based on the theoretical and conceptual discussions.

2.1 Underpinning Theory

In this section, we will delve into the foundational theories that serve as the bedrock for this study. These theories provide the necessary theoretical framework that guides the research process. They offer a lens through which we can better understand and interpret our research findings. We will explore each theory in detail, discussing its origins, key concepts, and relevance to our study. This comprehensive examination will not only enhance our understanding of the phenomena under investigation but also shed light on the relationships between corporate governance, risk disclosure, and financial performance.

2.1.1 The Agency Theory

The Agency Theory, first proposed by Jensen and Meckling in 1976 (Beal Partyka, 2022), describes a contractual relationship between principals and agents, where decision-making authority is transferred from the former to the latter. This theory has been further developed in recent years, with researchers highlighting the potential for agency costs to arise due to differing preferences between managers (agents) and company shareholders (principals).

In 2021, a study found that these agency costs could be mitigated through optimal contracts and voluntary disclosure. This perspective was further supported by another study in the same year, which emphasized the role of agency theory in understanding corporate governance. The study suggested that corporate governance could serve as an internal control to reduce agency conflicts and improve disclosure practices.

Fast forward to 2022, a systematic literature review across four disciplines explained the connection between governance mechanisms and supply chain relationship types through the lens of agency theory. The review provided valuable insights into the dynamics of performance, risk, sustainability, dyadic and inter-firm relationships, and supplier management (Matinheikki et al., 2022).

In 2023, a study expanded on the traditional set of governance mechanisms, providing academics and practitioners with a bigger "menu" of options to consider. The study took a step towards a "supply chain-oriented agency theory", explaining and predicting relationship types and governance in supply chains. This ongoing research highlights the relevance and applicability of the Agency Theory in various contexts.

2.1.2 The Signalling Theory

The Signalling Theory, first discussed by Robert Jervis in 1970 and later developed by Spence in 1973, explains how market reactions are influenced by signals or information conveyed by companies. This theory has been further developed in recent years, with researchers highlighting the potential for companies to use disclosure as a signalling mechanism (Pink et al., 2023).

In 2021, a study found that companies with strong performance tend to use disclosure as a signalling mechanism, which can enhance their share price and reduce associated risks and capital costs. This perspective was further supported by another study in the same year, which emphasized the role of signalling theory in understanding corporate governance (Yang et al., 2022).

Fast forward to 2022, a study found that small and medium-sized enterprises' quality management can promote supply chain financing performance, providing an explanation based on signalling theory. The study provided valuable insights into the dynamics of performance, risk, sustainability, dyadic and inter-firm relationships, and supplier management.

In 2023, a study expanded on the traditional set of governance mechanisms, providing academics and practitioners with a bigger “menu” of options to consider. The study took a step towards a “society-oriented signalling theory”, explaining and predicting relationship types and governance in societal contexts. This ongoing research highlights the relevance and applicability of the Signalling Theory in various contexts.

2.1.3 Corporate Governance and Risk Reporting in the Indonesian Context

The 2020s have witnessed a significant amount of international corporate failures that triggered the urgency for good corporate governance, accountability, social duty, higher transparency, and proper disclosure practices (King Committee, 2022). Realising the need to have better management, countries worldwide, including Indonesia, have started to improve their corporate governance (Aguilera & Cuervo-Cazurra, 2023). In Indonesia particularly, the government has administered a number of measures to improve the current corporate governance practice and disclosure standards (Akhtaruddin et al., 2023). Therefore, this study will focus on examining the impact of corporate governance on risk disclosure among listed companies in Indonesia.

The Agency Theory and Stakeholder Theory are central to understanding the dynamics between corporate governance, performance, and risk disclosure. The Agency Theory posits that there is an inherent conflict of interest between managers (agents) and shareholders (principals). Good corporate governance practices can mitigate this conflict and ensure that managers act in the best interest of shareholders. This, in turn, can influence a company’s performance and its approach to risk disclosure.

2.2 Conceptual Framework

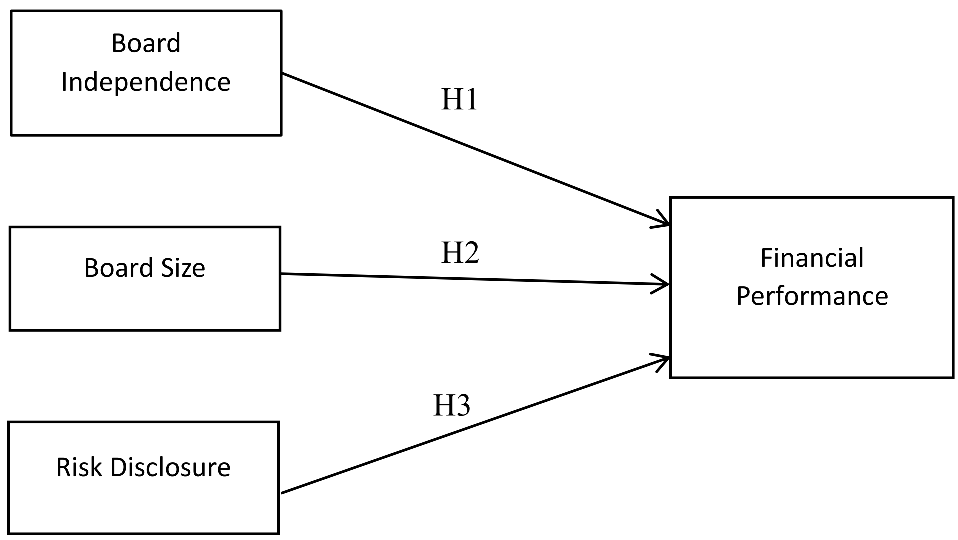

Figure 2.1 Theoretical Framework of the Study

2.3 Hypotheses Development

This study aims to examine the impact of board characteristics on financial performance in Indonesian listed companies. It focuses on three characteristics: board independence, board size, and risk disclosure. Hypotheses have been developed to test the relationships between these characteristics and financial performance practices. The findings will provide insights into corporate governance and transparency in Indonesian listed companies.

2.3.1 Board Independence

The effectiveness of corporate governance in mitigating agency conflict between management and shareholders is largely dependent on the degree of board independence. Studies conducted in Indonesia from 2021 to 2023 have shown that the proportion of independent directors on the board influences a company's voluntary and mandatory disclosures.

Independent directors play a crucial role in promoting disclosure motivation and improving agency cost. There is a documented relationship between the number of independent directors on the board and the disclosure practices of the company. It has been found that a manager’s opportunistic behavior can be reduced through the monitoring activity by independent directors.

However, boards with a higher number of independent directors tend to have poor disclosure practices due to a complex board structure. This might be because the board relies on the top executive for information and decision making as the independent directors and manager do not share a similar objective.

Despite these challenges, due to the higher degree of accountability, independence, and responsibility of an independent director, they are more prone to stakeholder’s demand for disclosure which at the same time motivates the manager to practice higher disclosure. Therefore, it is expected that a higher proportion of independent directors on the board will enhance disclosure practices in Indonesian listed companies (Salem et al., 2019).

H1: There is a positive relationship between a higher proportion of independent directors on the board and risk disclosure practices in Indonesian listed companies.

2.3.2 Board Size

Research conducted in Indonesia from 2021 to 2023 has found that companies with a large board size and a higher proportion of independent directors are less likely to have internal control issues of disclosure practices. This suggests that companies with a large board size have an additional monitoring agent to oversee managerial behavior, which improves internal control issues and promotes disclosure.

However, a large board size does not necessarily yield positive results. It has been documented that a large board size is associated with ineffective communication and coordination, leading to poor decision-making. Moreover, the relationship between board size and information disclosure is mixed.

The Agency Theory posits that to lower the agency conflict, companies must improve their corporate governance mechanism. It is argued that a larger board is capable of monitoring managers’ self-opportunistic behavior. A larger board is associated with the board’s diverse experiences, which is capable of handling a manager’s self-opportunistic behavior and improving transparency (Viola et al., 2023).

H2: There is a positive relationship between a larger board size and risk disclosure practices in Indonesian listed companies.

2.3.3 Risk Disclosure

Risk disclosure is a critical aspect of corporate governance. It involves the practice of providing information about the various risks that a company faces. This helps stakeholders, particularly investors, make informed decisions. In the context of this study, risk disclosure refers to the extent to which Indonesian listed companies disclose their risk-related information (Raimo et al., 2022).

The level of risk disclosure can be influenced by various factors, including board independence, board size, and board gender diversity. These factors can either promote or hinder the practice of risk disclosure. For instance, a board with a higher proportion of independent directors or larger size may encourage greater risk disclosure due to increased monitoring and diverse experiences. Similarly, a multi-gendered board may also enhance risk disclosure practices due to the varied perspectives and demands for better and sustainable reports.

However, it’s important to note that these relationships are not always straightforward. For example, boards with a higher number of independent directors or larger size may also face challenges such as complex board structures or ineffective communication, which could potentially lead to poor disclosure practices. Therefore, it’s crucial to consider these factors when examining the relationship between board characteristics and risk disclosure practices in Indonesian listed companies.

2.3.4 Financial Performance

The financial performance of a company is a key indicator of its overall health and long-term viability. In the context of Indonesian listed companies, financial performance can be influenced by various factors, including board characteristics and risk disclosure practices.

Research conducted from 2021 to 2023 has indicated that companies with robust risk disclosure practices tend to perform better financially. This is because comprehensive risk disclosure can reduce information asymmetry, enhance investor confidence, and potentially lead to a lower cost of capital.

Moreover, board characteristics such as board independence and board size can also impact a company's financial performance. A board with a higher proportion of independent directors can provide effective oversight and mitigate agency conflicts, leading to improved financial outcomes. Similarly, a larger board size can bring diverse perspectives and experiences, contributing to better decision-making and financial performance.

However, the relationship between these factors and financial performance is complex and can be influenced by various other factors, such as the company's industry, size, and regulatory environment. Therefore, it is crucial to consider these factors when examining the impact of board characteristics and risk disclosure practices on financial performance.