Chapter II

Theoretical Background and Previous Research

A. Theoretical Background

1. What is Good Corporate Governance?

The definition of corporate governance is varying. Report of SEBI committee (India) on Corporate Governance defines corporate governance as the acceptance by management of the inalienable rights of shareholders as the true owners of the corporation and of their own role as trustees on behalf of the shareholders. It is about commitment to values, about ethical business conduct and about making a distinction between personal & corporate funds in the management of a company.

From Wikipedia (2010), Business author Gabrielle O'Donovan defines corporate governance as 'an internal system encompassing policies, processes and people, which serves the needs of shareholders and other stakeholders, by directing and controlling management activities with good business savvy, objectivity, accountability and integrity. Sound corporate governance is reliant on external marketplace commitment and legislation, plus a healthy board culture which safeguards policies and processes. O'Donovan goes on to say that 'the perceived quality of a company's corporate governance can influence its share price as well as the cost of raising capital.

According to Stijn Claessens (2003) corporate governance tends to fall into two categories. The first set of definitions concerns itself with a set of behavioral patterns: that is, the actual behavior of corporations, in terms of such measures as performance, efficiency, growth, financial structure, and treatment of shareholders and other stakeholders. The second set concerns itself with the normative framework: that is, the rules under which firms are operating with the rules coming from such sources as the legal system, the judicial system, financial markets, and factor (labor) markets.

For studies of single countries or firms within a country, the first type of definition is the most logical choice. It considers such matters as how boards of directors operate the role of executive compensation in determining firm performance, the relationship between labor policies and firm performance, and the role of multiple shareholders. For comparative studies, the second type of definition is the more logical one. It investigates how differences in the normative framework affect the behavioral patterns of firms, investors, and others.

A somewhat broader definition would be to define corporate governance as a set of mechanisms through which firms operate when ownership is separated from management. This is close to the definition used by Sir Adrian Cadbury, head of the Committee on the Financial Aspects of Corporate Governance in the United Kingdom:

"Corporate governance is a set of rules that define the relationship between shareholders, managers, creditors, the government, employees and other internal and external stakeholders in respect to their rights and responsibilities, or the system by which companies are directed and controlled" (Cadbury Committee, 1992).

An even broader definition is to define a governance system as *"the complex set of constraints that shape the ex post bargaining over the quasi rents generated by the firm"* (Zingales, 1998: 499). This definition focuses on the division of claims and can be somewhat expanded to define corporate governance as *the complex set of constraints that determine the quasi-rents (profits) generated by the firm in the course of relationships and shape the ex post bargaining over them*. This definition refers to both the determination of value-added by firms and the allocation of it among stakeholders that have relationships with the firm. It can be read to refer to a set of rules, as well as to institutions.

Corresponding to this broad definition, the objective of a good corporate governance framework would be to create added value and to maximize the contribution of firms to the overall economy that is, including all stakeholders. Theoretically, implementation of good corporate governance to enhance shareholder value, by improving their financial performance, reduce risks that may be done by the board of commissioners with decisions that benefit themselves and generally good corporate governance to enhance investor confidence (Tjager et al., 2003). Under this definition, corporate governance would include the relationship between shareholders, creditors, and corporations; between financial markets, institutions, and corporations; and between employees and corporations. Corporate governance would also encompass the issue of corporate social responsibility, including such aspects as the dealings of the firm with respect to culture and the environment.

2. The Benefits of Implementing Good Corporate Governance

By applying Corporate Governance to the companies, there are some benefits that could be gained. The benefits are as follows (FCGI.or.id):

a. Easier to rise capital; easier to obtain better and lower cost capital in order to enhance the corporate value.
b. Improved business performance and improved economic performance; improving business performance through the process of making better decisions, improve operational efficiencies enterprise and further improve service to stakeholders.
c. Good impact on share price; it can increase the share price indirectly when the investors feel satisfied with the company performance.
d. Restoring the investors trust to invest in Indonesia.

International principles for corporate governance are emerging. These principles cover:

a. the rights of shareholders, who should be timely and properly informed about the company, who should be able to participate in decisions concerning fundamental corporate changes, and who should share in the profits of the company;
b. equitable treatment of shareholders, especially minority and foreign shareholders, with full disclosure of material information and prohibit abusive self dealing and insider trading;
c. the role of stakeholders should be recognized as established by law and active co-operation between corporations and stakeholders in creating wealth, jobs and financially sound enterprises;
d. timely and accurate disclosure and transparency on all matters material to company performance, ownership and its stakeholders;
e. The responsibilities of the board in the management, the supervision of the management and the accountability to the company and shareholders.

The government plays an important supporting role by issuing and enforcing adequate regulation on for instance company registration, disclosure of financial company data and rules on the responsibilities of commissioners and directors. The company however has the prime responsibility for implementing a system of good corporate governance within the company. The company should recognize the importance that a system of good corporate governance has for the interests of its shareholders, its financiers and its employees, and therefore, for the company itself. Companies should anticipate stronger enforcement of existing laws and regulations, the introduction of new regulations and increasingly strong public scrutiny over their actions.

3. **Parties Involved in Good Corporate Governance**

At the beginning when good corporate governance was really needed and became popular, a party who was considered to be the most responsible for the success of good corporate governance is the board of directors, especially in companies listed on U.S. capital markets, which perform oversight functions, enforcement, supervisory, as well as advisory. Along with the increased complexity and risks of the functions associated with the CG developed, and carried out by several participants. Here are 5 participants who can be associated with the functions performed in the development of good corporate governance.

a. The boards of directors (BoD) are persons who responsible to the overall process of the company to accomplish its goals. Brountas (2004) stated that economy crisis, which was happened in America, was caused by the dependent Board of Directors, Board of Directors who lack of knowledge of their business company condition, do not attend board committee meeting, could not understand company's strategies, and also could not work well in a group. There are several factors that affected the effectiveness performance of Board of Director, Anand (2008): board size, system of appointment the board, profile of BoD members, competency and independency of BoD members.

b. Chief Executive Officers (CEO); their primary task is enforcing the functional system and saving the company's assets. Anand (2008), there are several task and jobs related to CEO, such as do their role to represent their company and create company's schedules, as facilitators of board members to accept appropriate information timely as foundations for making decision, protect shareholder rights.
c. Board of Commissioners (BoC); commonly, there are two types of BoC, the first is one tier system called as Anglo Saxon, and the second is two tier systems occurred in Europe. Anglo Saxon only has one BoD whose jobs are combined between manager (executive director) and independent director (nonexecutive director). U.S. and England use this system. While continental Europe has two different parties (BoC and BoD). BoD works under BoC control. BoD could be appointed and eliminated by BoC. BoC is selected by *RUPS*. Countries that use two tiers system are Denmark, German, Holland, Japan, and also Indonesia.
d. Auditors, including internal auditors and external auditors; mainly perform the function Assurances.
e. Stakeholders, including, among other shareholders, creditors, governments, customers, and society and the environment; mainly perform the function of monitoring.

4. Entities or Institutions Regarding to Good Corporate Government

Since many scandals within companies are revealed, Corporate Governance was frequently noticed by many corporate in the world. The encouragement of applying Corporate Governance should come from internal company and also from the third party or entities regarding to Good Corporate Governance.

In International such as America, congress legitimated Sarbanes Oxley Act (SOA) to maintain the companies' accountability and also to establish the investor trust. Organization for Economic Co-Operation and Development (OECD) which is an international organization intending to support economy growths and to support the implementation of Corporate Governance. OECD was established in 1961 and its members contain of many countries.

While in Indonesia, Indonesia has several institutions regarding to Good Corporate Governance. They were formed to promote and to encourage companies to implement GCG. There are KNKG, FCGI, IICG, and also CGCG UGM. FCGI stands for Forum for Corporate Governance in Indonesia. FCGI was built in year 2000 by 5 associations videlicet: *Asosiasi Emiten* Indonesia (AEI), *Ikatan Akuntan Indonesia-Kompartemen Akuntan Manajemen* (IAI-MAC), Indonesian financial Executives ssociation (IFEA), Indonesia Netherlands Association (INA), and *Masyarakat Transparansi Indonesia* (MTI). FCGI has main purpose to increase the responsiveness and to socialize the principal of Good Corporate Governance toward Indonesian Business communities, in order to receive the benefit of managing well companies.

5. The Principles of Good Corporate Governance

The basic principle of good corporate governance is expected to be the main point of reference for the regulator (government) in building the framework for the implementation of good corporate governance. For business and capital markets of these principles can be a guidance or guidance in elaborating best practices for improving the value and viability of the company.

In our country, Indonesia, based on the guideline which is made by Komite Nasional Kebijakan Governance (KNKG), "Pedoman Umum Good Corporate Governance Indonesia", there are five fundamental principles that have to be implemented by a company to reach the sustainability with a respect to the stakeholders. Those principles are:

a. Transparency; to ensure that objectivity is always implemented in a business, a company must provide material and relevant information that can be accessed and understood easily by the stakeholders. A company must take an initiative to tell not only problems that are obligated by the law but also other important things for the decision making by the shareholders, creditors and other shareholders.

b. Accountability; Company must show their responsibilities of what they have done transparently and properly. Therefore, the company have to be organized properly, measurably and be fitted with company`s interests but the company must still think about the shareholders` interests and other shareholders.

Accountability is one of the most important things that is needed to reach the sustainable performance.

c. Responsibility; A company must pay attention and implement not only the laws but also their responsibilities to the communities and the environment so that in the long term, business` sustainability can always be reached. Not only that, the company will get recognition as a good corporate citizen.
d. Independency; In order to smoothing the implementation of the GCG principles, the company must be run independently so that every business units in the company will not dominate each other and cannot be intervened by other parties.
e. Fairness; when companies run their business, they must always consider the shareholders` and other stakeholders` interests based on the fairness principles.

According to CGCG UGM, CGCG rely on 5 principles that should be met Corporate Governance, these are:

a. Transparency; in carrying out its functions, all participants must submit the information material in accordance with the actual substance, and make that information accessible and easily understood by the other parties concerned.
b. Accountability & responsibility; in carrying out its functions, each participant must give an explain CG mandate received in accordance with the laws, regulations, standards of moral / ethical and best practices generally

acceptable, and setting up the proposed responsibility if accountability are rejected.

c. Responsiveness; in carrying out its functions, each participant must respond CG, also includes anticipatory activity, the demand (requests) and the feedback (feedback) the parties concerned and to the business world changes a significant effect on the company.

d. Independence; in carrying out its functions, each participant must free itself from the interests of other parties potentially create conflicts of interest, and perform its functions in accordance adequate competence.

e. Fairness; in carrying out its functions, each participant treat others fairly based on the provisions grateful public.

6. Financial Performance

Financial performance is one of the indicators whether company operates their systems effectively and efficiently or not to achieve its goals. It is effective when managers can define good goals and have good tools to reach the targeted goals. While efficient is a ratio between output and input where the minimum output could be formed into maximum inputs.

Many mathematical measurements can be used to measure how well a company using its resource to make profits. The term of financial performance is also used as a general measure of a firm overall financial health over a given time period, also used to compare similar firms across the same industry or different industries. There are several ways to measure the financial performance, such as liquidity, profitability, efficiency, capital structure, etc.

Liquidity refers to the speed which an asset can be converted to cash. Any assets can be converted to cash quickly if we lower the price. Therefore a highly liquid asset is one that can be quickly sold without lowering the value. An illiquid asset is one that cannot be quickly converted to cash. Fixed assets are, for the most part, relatively illiquid. These consist of tangible things such as buildings and equipment which is not converted to cash at all in normal business activity (they are, of course, used in the business to generate cash). Intangible assets, such as a trademark, have no physical existence but can be very valuable. Like tangible fixed assets, they won’t ordinarily convert to cash and are generally considered illiquid.

Capital structure is referred to how a company leverage or finance their capital. It can be done by using different composition of capital structure and combining among equity, debt or hybrid securities.

7. The Purpose of Firm Valuation

Assessing the firm performance or Firm Valuation is often made for such these purposes according to Darmawati (2004):

1) For the purposes of mergers and acquisitions. The company will undertake merger or acquire another company, obviously needs assessment activities to determine how the value of the company is and its shareholders' equity of each company.

2) For the purpose of restructuring and business interests. Companies with problems often require an assessment to implement a restructuring program or business recovery, to determine whether business value is greater than the value of liquidity or not.
3) For the purposes of divestment as a stock company from a strategic partner (some stock should be removed to a new partner). For example: privatization of SOEs.
4) For Initial Public Offering (IPO) Companies that will sell or exchange their shares in general, should be assessed by using a fair assessment to be offered to the public or the public.
5) To obtain a fair income for inclusion in a company or indicate that the company is worth more than what is in the balance sheet.
6) Getting a loan or determining the amount of spending additional capital.

B. Previous Research Used

Several previous researches ever conducted on the application of good corporate governance, particularly with respect to these researches; the first is research conduct by Drobetz et al. 2003, a study of listed companies in the German capital market, which implement good corporate governance. This study aims to determine the effect implementation of good corporate governance on stock performance measured by using the expected stock return. Sample companies are involved in the research, 91 companies, with a 50-month observation period. The result of this study indicates that good corporate governance has positive and significant impact on expected return. After that Bauer et al. (2003) also conducted a study on the implementation of GCG in European companies. This study aims to determine the effect of GCG implementation of a valuation firm that is proxy with Tobin's Q and company performance is proxy by with ROE and NPM. Samples used in these studies are that companies included in the FTSE Eurotop 300 during the period 2000 to 2001. The results of this study indicate that the implementation of GCG significant effect on Tobin's Q, ROE and NPM.

Goes Further Brown and Caylor. (2004) had a study of listed companies in the New York Stock Exchange and implement good corporate governance. The study aims to determine the effect of good corporate governance on firm performance (which is proxy with ROE, Net Profit Margin, Sales Growth, and Tobin's Q). The results of this study indicate that, good corporate governance and significant positive effect on firm performance.

In 2005 GCG implementation also studied by Jandik and Rennie. They conducted research on the effect of GCG implementation on the performance of publicly traded companies in emerging capital markets (emerging markets). This study aims to determine the effect of GCG implementation of company performance is proxy with profitability ratios, activity ratios, liquidity ratios and leverage ratios. The results of this study indicate a significant influence of the GCG implementation on firm performance. Also with Gruszczynski (2006) conducted research on these companies goes public in Poland. The main purpose of this study was to determine the effect of the GCG implementation of the company's financial performance. The samples are companies that are included in the company seeded by Polish Corporate Governance

Forum. The results of this study show the influence of the GCG implementation of the company's financial performance.

Klapper and Love (2002) found a positive relationship between corporate governance with firm performance. This study uses data from credit reports Lyonnals Securities Asia (CLSA), which form the application of corporate governance ratings for 495 companies in 25 countries, in this study measured firm performance by using Tobin's Q as a measure of market valuation and Return on Assets (ROA) as a measure of the company's operational performance. The results of this study indicate that companies that implement good corporate governance will gain greater benefits in the countries that poor legal environment.

Table 1
Previous Research

Researcher	Research Title	Variable	Method	Result
Klapper and Love (2002)	Corporate Governance, Investor Protection and Performance in Emerging Markets	Corporate Governance, legality, Tobin's Q, Return On Equity (ROE)	OLS univariate and Multivariate Regressions	The better corporate governance is highly correlated with better operating performance and market valuation
Marek Gruszczynski (2006)	Corporate governance and financial performance of companies in Poland	Corporate Governance degree (CG), Profitability Ratio, Liquidity Ratio, Activity Ratio, and Debt Ratio	Ordered Logit	The level of corporate governance of companies in Poland is associated by their ability to cope with the financial distress
Drobetz et al. (2003)	Corporate Governance	Corporate Governance	Simple Regression	Positive relationship between the CGR and

	and Expected Stock Returns: Evidance From Germany	rating (CGR), market-to-book ratio.		firm value
Bauer et al. (2003)	Empirical Evidence on Corporate Governance in Europe: The Effect on Stock Returns, Firm Value and Performance	Market Risk, Market Capitalization, book-to-market ratio, Return On Equity (ROE), Corporate Governance	Multivariate Regression	A positive relationship between these variables and corporate governance.
Lawrence D. Brown and Marcus L. Caylor (2004)	Corporate Governance and Firm Performance	Tobin’s Q, GOV-score, Log of Asset, Log of firm age, and a dummy for incorporation	Regression	Better-governed firms are relatively more profitable, more valuable, and pay out more cash to their shareholders
Tomas Jandik and Craig G. Rennie (2005)	The Evolution of Corporate Governance and Firm Performance in Emerging Markets: The case of Sellier and Bellot	Profitability Ratios, Activity Ratios, Liquidity Ratios and Leverage Ratios	-	Exogenously imposed diffuse ownership, combined with legal, capital market, and accounting deficiencies, contributed to poor corporate governance and weak firm performance.

Source: Developed from some journals

C. Hypothesis Development

Good corporate governance is a set of rules that regulate relations between shareholders, managers (management) company, the creditors, governments, employees and stakeholders other internal and external relating to the rights and obligations or in other words is a system to regulates and control the company, the aim to increase the adding value for all parties. If the implementation of good corporate governance can be run effectively and efficiently to the whole process of company's activity, so that all matters relating to good corporate performance whether it is financial performance or it isn't financial performance will also good (Brown and Caylor., 2004).

There is also a research conducted by Alexakis et al. (2006) to companies listed in the Greek capital market indicates that companies which already applied good corporate governance are able to increase their stock return rate. Next, with a research conducted by Sukamulja (2004) stated that the most important to use GCG is to improve the financial performance and to keep the investors feel save. It is occurred automatically when the investors feel the safety is guaranteed then the risk is getting lower. "High risk high return, low risk low return" is valid to explain this. It is because risk reflects the cost; the higher willingness of compensation as a return the higher cost will be needed and vice versa. The good financial performance will attract investors to invest there. The more investors invest there make the natural law of economic working here. The more demand of company's stocks make its price increasing. The increasing of stock price increases the market value. From the market value which can be measured by Tobin's Q ratio, the prospect of a company can be seen whether it still cans growth in the future or not.

Based on those evidences, so that Tobin's Q which is calculated using market value divided by asset value is impacted by the implementation of GCG within company. Then the hypothesis proposed in this study is:

Ha: The implementation of Good Corporate Governance impact to Tobin's