CHAPTER II

LITERATURE REVIEW

2.1. Good Corporate Governance (GCG)

Corporate governance issues is rising since the separation of the ownership and the management (Jil and Aris Salomon, 2004). Tricker (1994) argued, the managing power of corporation come from the ownership. The owner is expected to run the corporation based on their investment value. And therefore, the owner will delegate the power to the professional team known as the management team to supervise the investment.

The separation power of the owner and the management team creates a problem named agency problem. This problem occured because there is a dominant position of the management who operates and controls daily operation of the corporation. Sometimes they act beyond the limits and forget the ultimate purpose of maximizing shareholders value. This contradiction needs to be solved by the existence GCG practices.

As a popular concept nowadays, GCG has not only one single definition. GCG is a principal underlies a process and corporate mechanism based on the Peraturan Perundang-undangan and business ethics. And according to Cadburry Committee on Cadburry Report (1992), GCG is a principal that direct and control a corporation to achieve balancing between power and authority in their responsibility to the shareholders. A group of developing countries, Organization for Economic Cooperation and Development (OECD) also stated GCG as the way of management responsible to their shareholders by responsible decision and having the value added. And last, Forum for Corporate Governance in Indonesia (FCGI) defines corporate governance as a set of rules which regulate relation among shareholders, management, creditor, government, employees, and internal and external relations. In other words, corporate governance is a system that regulates and controls a corporation.

Definitions above conclude that the importances aspects of GCG are the balance of corporate components, fulfilled the responsibilities to the shareholders, fulfilled shareholders rights of information and decision, and equitable treatment of the shareholders. Gede Raka in the book of *The Power of Corporate Governance* stated that a corporation is a human institution includes people with value, dreams, identity and social responsibilities. GCG concept reflect the importance of sharing, caring, and conserve which be as the deepest aspect of GCG. Basically, corporate governance is primarily concerned with finding a solution to the principal-agent problem. The principal, is seeking ways to ensure the agent (management) handle their investment in such a way as to guarantee maximum returns for them as investors and other stakeholders (Agarwal and Knoeber, 1996).

Purpose of GCG is to create and maximize the value added for all shareholders. Theoritically, GCG practice increases firm value by increasing firm performance and lowering down the possibility of risk occured from the self-benefit decision by the board members. In overall, GCG could increase investors trust (Tjager, et al., 2003).

2.2. Basic Theories and Studies Related to GCG

Two basic theories related to GCG are stewardship theory and agency theory.

2.2.1. Stewardship Theory

Stewardship theory was created based on philosophy assumption of the nature of man who is essentially trustworthy, able to act in good faith in the interest of others with integrity and honesty (Donaldson and Davis 1988). In other words, stewardship theory considered management do their job honestly for the public and shareholders interest.

Davis, Schoorman, & Donaldson (1997) argue related to the theory, that the managers or executives of a company are stewards of the owners, and both groups share common goals. Therefore, the board should not be too controlling, as agency theories would suggest. The board should play a supportive role by empowering executives and, in turn, increase the potential for higher performance (Hendry, 2002; Shen, 2003). This theory further argue for relationships between board and executives that involve training, mentoring, and shared decision making (Shen, 2003; Sundaramurthy & Lewis, 2003).

2.2.2. Agency Theory

Agency theory arise from the distinction between the owners (shareholders) of a company designated as "the principals" and the executives hired to manage the organization called "the agent." Agency theory argues that the goal of the agent is different from that of the principals, and they are conflicting (Johnson, Daily, & Ellstrand, 1996). Berle and Means (1932) contended that managers did not have the same interest and motivation as the owners to make full and efficient use of the corporate assets. The view of man taken by agency theory is contrasted to the stewardship theory. In this theory, managers could not be trusted to act in the public good in general and in the interest of the shareholders in particular. Briefly, managers could not be trusted to do their job which of course is to maximize shareholder value (Tricker).

Agency theory had wider responses from the society because it closely reflects reality. According to this theory, corporate management need to be supervised and controlled to make sure the business ran based on the regulations. This effort creates costs to reduce the possibility of disobedience which known as the agency costs. Agency costs includes cost of shareholders supervision, management cost to provide transparant financial report, and audit and internal control cost.

Comparation between the activity of corporate governance and corporate management describes that corporate governance focused on supervise and accountability aspect. Hence, corporate management focused on controlling decision and operational management.

2.3. Good Corporate Governance (GCG) General Principles

Good Corporate Governance (GCG) general principles consist of five basic principles as stated by National Committee on Governance Indonesia. It includes Transparency, Accountability, Responsibility, Independency, and Fairness (TARIF).

2.3.1. Transparency

Transparency obligates an open information that is published in time, clear, complete, and comparable. It concerns financial, management, operational performance, and ownership informations. To preserve and maintain the objectivity in practicing business, a company must provide material and relevant information that are easily accessible and understandable by stakeholders. According to the regulation of Indonesia capital market, material and relevant means informations which affect the fluctuation of corporate share price then will affect the risk and prospect of the corporation. A company must take the initiative to disclose not only the issues mandated by laws and regulations, but also other information deemed necessary by shareholders, creditors and other stakeholders to form a decision.

Benefits of the application of transparency are shareholders could know the possibility of risk occured in doing transactions to the corporation. Hence, there will be the possibility of market efficiency and avoid the conflict of interest among parties in the management team.

2.3.2. Accountability

Accountability is a set of clear function, structure, system, and responsibilities of corporate organs so that the corporate management could work effectively. It includes the clear format of rights, obligations, and responsibilities among shareholders, commissioners and directors. This complete function will avoid any problem related to the division of authority and agency problems occured.

A company must be accountable for its performance transparently and fairly. Thus, a company must be managed in a proper and measurable manner, in such that it is aligned with the interest of a company by also considering the interest of shareholders and other stakeholders. Accountability is a prerequisite to achieve sustainable performance.

2.3.3. Responsibility

A company shall abide by laws and regulations and fulfill its responsibility to the communities and environment for the purpose of maintaining long term sustainability of the business and to be recognized as a good corporate citizen.

2.3.4. Independency

To accelerate the implementation of the GCG principles, a company must be managed independently with an appropriate balance of power, in such a manner that no single company's organ shall dominate the other and that no intervention from other party shall exist.

Independency is crucial in decision making process. Lost of independency in decision making means the lost of objectivity, and will be terrible if corporate importance have to be seconded. To increase independency in business decision, corporate should develop some rules, guidances, and practices in corporate board especially in the level of Board of Commissioners and Directors.

2.3.5. Fairness

Fairness simply defines as an equitable manner of all shareholder rights as written in the agreement and the Peraturan Perundang-undangan. Fairness involves clear rights of capitalists, law system, and the establishment of regulation to protect shareholder rights and avoid any fraudulence activities.

There will be benefits of the execution of this principal, corporate assets are managed in prudent which hence will provide protection to shareholder rights. Fairness is expected to avoid any form of corporate harm activities. Shortly, it could guarantee fairness among interests in corporation.

2.4. Factors Defining The Success of Good Corporate Governance (GCG)

There are factors defining the success of GCG practices, internal factor and external factor.

1. Internal Factor

   Internal factor is the success factors from the inside of corporation, includes corporate culture, which support GCG practices in mechanism and management work system in the corporation, rules and regulation related to the GCG practices, corporate risk management, effective audit system to reduce the possibility of fraudulent activity, and information disclosure to public.

2. External Factor

External factor is every factors from the outside of corporation which affect the success of GCG practices. It includes law system to guarantee the effective and consistent supremacy of law. Besides, other support from public sector or government institution also affect GCG success. Best practices of the practices is needed as the benchmark to build social value in the society. Moreover, the spirit of anticorruption in Indonesia is also important followed by the construction of education which hence will wider the jobfield.

Despite of two factors above, the other aspects to support GCG practices effectively are quality, skill, credibility, and integrity from all parties in the corporation.

2.5. Indicator of Good Corporate Governance (GCG)

There are four main points in measuring GCG practices in Korea based on the study of Black, Jang, Kim (2003). Some factors affecting GCG are shareholder rights, board of commissioners and outside commissioners, audit committee, disclosure and ownership parity.

2.5.1. Shareholder Rights

Sylvia Veronica Siregar (2017) in the book of *Corporate Governance in Developing and Emerging Markets* had explained basic shareholder rights such as secured ownership registration, having adequate information on timely and regular basis, and transferring shares, particiapating and voting in general meeting, removing board member, and sharing profit of the corporation (OECD, 2015). Balance of ownership structure and rights and providing shareholder rights properly will increase their prosperities and wealths. And it will increase their demand of buying shares which affect to the rising share prices in the market. Each shareholder have to know their rights and consult each other to form good corporate governance.

Efendi (2015) stated, share prices showed firm value, if one increases, others will increase too. In other words, share price increases caused by one of the factor of the shareholders prosperity and it will be achieved by fulfilling their rights. Therefore, fulfilled shareholder rights, higher their prosperity, will rise corporate share prices and the firm value.

2.4.2. Board of Commissioners and Outside Commissioners

Board of commissioners is the core of corporate governance who has duty to ensure corporate strategy, management supervise, and controlling accountability (Egon Zehnder International in FCGI 2006). It is the center of endurance and success of the corporation. Other argument from Young (1998) argued, role of the board of commissioners is matter in improving company performance by pressing the manipulation of earnings and provide assurance on the proper information about the company's operations. GCG should be supported from the higher level that is the board of commissioners to increase the effectivity hence will increase firm value.

Besides, outside commissioners has function to solve agency conflict inside corporation. They could communicate the purpose of every shareholders to the management team. Dechow et al. (1996) stated, the independency of corporate board will reduce the fraudulent activities in the financial report. The existence of outside commissioners is expected to increase the effectivity og supervising and the quality of financial report. Better the quality of financial report increase investor trust and let them invest more to the corporation. More shares are invested will increase share price and thus increase firm value.

2.4.3. Audit Committee

As written in Crisan *et al.* (2014) study, a group of researchers suggests that the audit committee play a large role in consolidation of financial control within a company (Collier, 1993; Vinten & Lee, 1993). A number of studies have found that inside of companies with an audit committee, particularly when the committee is active and independent, there is less chance for the occurrence of fraud (Beasley et al., 2000; Abbott et al., 2000, McMullen, 1996) and other irregularities reporting (McMullen, 1996). The audit committee has responsibilities, monitoring the financial reporting process, monitoring the effectiveness of internal control or internal audit, as appropriate, and risk management of the company, monitoring the statutory audit of annual financial statements and the consolidated annual financial statements, and monitoring the independence of the statutory auditor of the company. The existence of audit committee plays the key element in supporting the embodiment of GCG. Naturally, it could lower down the possibility of the errors in financial reporting, the earnings management methods to smooth income, the compliance with GAAP, the reliability of the accounting numbers, and the confidence of the balances. Hence, it is all for the harmony between the interest of management, shareholders, investors, regulator, and public.

2.4.4. Disclosure

Glosten and Milgrom (1985) in Sugito (2012) stated, disclosure used to reduce the information assymetry which then could decrease the possibility of earnings management in the corporation. Investors could value a corporation by the items that the corporate disclose. More disclosure will increase their trust to invest more to the corporation. Through information disclosure, corporate could lower down the uncertainty of the corporate future prospect. This activity will increase trading volume and increase share price in the market which reflect firm value.

2.6. Firm Market Value

Brealey et. al (2007:46) defines firm value as investors' collective assessment of how well a corporate condition today and in the future. Husnan (2000:7) suggests, firm value is the price that buyer is willing to pay if the corporation is sold. It could be interpreted through its share prices, higher the share price so do the firm value and the reverse. Firm value also defines as market value because firm value provide shareholders prosperous if share price is increasing. Every policy adopted by the management to improve firm value by maximizing shareholder value reflected from the share prices (Bringham and Houston, 2006 : 19). Ultimate purpose of the corporation is maximizing firm value. Because it will increase prosperity of the corporate owner (Husnan, 2000 : 7). Firm market value describes how well management controls their assets, which could be observed by their financial performance. Samuel in Johan (2010:24) stated, firm value is the important concept for the investors because it is the indicator to value the corporate as a whole.

According to definitions of firm value above, it concludes that firm value is the core value which could be identified by the share prices in the market. Therefore, high share price indicates high value of corporation.

2.6.1. Measurement of Firm Market Value

Firm value is measured by the assessment ratio or market ratio. Assessment ratio is the overall financial performance measurement. Some indicators to measure firm value :

1. Price to Earning Ratio (P/E Ratio)

   P/E ratio indicates the dollar amount an investor can expect to invest in a company in order to receive one dollar of that company's earnings. P/E is sometimes referred as the price multiple because it shows how much investors are willing to pay per dollar of earnings. Higher P/E ratio, higher firm possibility to grow and increase its value.

P/E ratio can be calculated by the formula :

$$\textbf{P/E Ratio} = \frac{\textbf{Share price}}{\textbf{Earning Per Share}}$$

P/E Ratio is imporant because :

1. P/E Ratio could help investor in comparing two firms directly and accurately.
2. Investors can compare firms in one industry and the average of firms in the market as a whole, hence could wider investors insight of undervalued or overvalued shares.

But, P/E ratio also has some weaknesses :

1. Manipulation of earnings. Most of firms often use techiques to manipulate net income that will make inaccurate result.
2. Different industries will make comparation of P/E ratio become harder. Because different industries will have different growth level, risk level, etc.
3. P/E ratio only includes two component in the measurement which ignore other important component such as future growth and prospect.

2. Price to Book Value (PBV)

Second measurement of firm value is Price to Book Value (PBV). Ang (1997) stated, PBV is a market ratio to measure share price over its book value. PBV shows how corporation creates corporate value in terms of price over the existing capital. Higher PBV means corporate success providing satisfaction and prosperity of shareholders. Where Suad (2001) stated, higher PBV higher corporate valuation by the shareholders compared to the fund invested in the corporation. Commonly, PBV result more than 1 means corporate market price higher than its book value. This result will thus rise investors trust to the corporate prospect in the future.

Ang and Robert (1997) formulate PBV ratio :

$$\mathbf{PBV} = \frac{\mathbf{Market\ Price\ per\ share}}{\mathbf{Book\ Value\ per\ share}}$$

Some advantages in using PBV to measure firm value are :

1. Investors find the PBV ratio useful because the book value of equity provides a relatively stable that can be easily compared to the market price.
2. PBV ratio can be used for firms with positive book values and negative earnings since negative earnings render price-to-earnings ratios useless, and there are fewer companies with negative book values than companies with negative earnings.

However, PBV ratio provide disadvantages below :

1. PBV ratio may not be comparable, especially for companies from different countries.

2. PBV ratio can be less useful for services and information technology companies with little tangible assets on their balance sheets.

Finally, the book value can become negative as a result of a long series of negative earnings, making the PBV ratio useless for relative valuation purposes.

3. Tobin's Q

Tobin's Q Ratio is introduced by James Tobin from Yale University who hold the Nobel Economics. His hypothesis stated, the combination of firm value of stock exchanges is equal to their replacement costs. Research from Sudiyanto and Puspitasari (2010) stated Tobin's Q is the ratio of market value measured by dividing total shares outstanding and liability with asset replacement cost. It is used to value market price because it is well-known in considerating the potential of share price growth, management capability in managing firm assets, and considerating investment growth. Tobin's Q could detect growth prospect, bigger the ratio means company have good prospect. And hence investors willing to give more in purpose of having the company. Sekaredi (2011) explained, company with high Tobin's Q usually have a strong brand image and lower Tobin's Q is common for competitive industries. (Brealey dan Myers, 2000).

Chung and Pruitt (1994) suggests the following Tobin's Q formula :

$$\textbf{Tobins ' Q} = \frac{\textbf{MVCS+PS+BVD}}{\textbf{Total Assets}}$$

Where :

MVCS = Market Value of Common Stock (Price of firm's common stock at the publication date of financial report x Number of common stock shares outstanding)

PS = Preferred Stock

BVD = Book Value of Debt

Brealey and Mayers (2007) stated, firm with high Tobin's Q usually have strong brand image, good growth prospect and bigger intangible assets. This because if firm value of the assets is high, investor is willing to sacrifice more to own the corporation. Lower Tobin's Q placed for the competitive and weaker industries.

There are advantages of using Tobin's Q :

1. Tobin's Q provide wide information and explain more phenomenon in the corporation such as the different cross-sectional in investment decision (Claessens and Fan, 2003 in Sukamulja, 2004), and relationship between management performance and benefit in acquisition (Gompers, 2003 in Sukamulj, 2004).
2. Tobin's Q considering share price growth, management potential, and investment growth (Sudiyatno dan Puspitasari, 2010).

3. Tobin's Q includes all aspect of debt and capital. Not only common stock and equity but also total assets.
4. Not only focus on fundamental aspect, but going wider in valuing the firm such as firm assets, corporate prospect, and intangible assets.
5. Tobin's Q focus on firm valuation which very useful in investor perpective.

Besides very useful for the investors financial analyst, Tobin's Q needs big amount of datas, extra time and extra energy to process all the datas. Thus, this measurement is not applicable for daily activities.

2.7. Factors Affecting Firm Market Value

2.7.1. Firm Size

Firm size is one of the important variable in determining firm market value. It is a total reflection of firm assets. Bigger the firm total assets bigger the firm size. Big number of total assets describe higher capability to finance operational and future obligations. Big firm usually obtained attentions more from the investors and wide society. Riyanto (2011) explained, a big firm with widely distributed shares will have more control in capital expansion and the reverse. Therefore, big firm tends to be brave in issuing more shares which will attract more investors and hence increasing firm value.

2.7.2. Firm Leverage

Leverage is a degree to which a company use its debt to covered its assets. More debt used by the company will determine higher degree of financial leverage. A high degree of financial leverage means high interest payments, and negatively affect the company's bottom-line earnings per share. Study from Ummi Isti'adah (2015) stated, high degree of leverage shows higher investment risk and the reverse. Therefore, higher leverage ratio could lower its market value.

2.8. Previous Studies

Several empirical studies confirm a positive link between specific corporate governance variables and firm performance. Many related studies explored whether corporate governance in its entirety has any relationship with firm performance or value.

Researcher studies and the results summarized below :

No	Author	Research
1	Patel and Dallas (2002)	Research by using Standard & Poor's Transparency & Disclosure (T&D) index and found that US companies can reduce their cost of equity capital by providing higher transparency and disclosure to the capital markets.
2	Brown and Caylor (2006)	They analysed 2,327 US firms with 51 factors based on data sets of Institutional Shareholder Services (ISS), and concluded that better-governed firms are

		relatively more profitable and valuable, and pay more cash to their shareholders.
3	Gompers *et al.* (2003)	He used a CGI and found that higher quality corporate governance was associated with improved future stock performance.
4	Klapper and Love (2004) and Durnev and Kim (2005)	They use a CGI, confirmed that corporate governance is an important factor in explaining the performance and market value of public companies in many emerging markets.
5	Black et al. (2006a, 2009b)	They use a CGI, found that corporate governance is important in the case of Korean public companies as well. This study also expect the positive relationship between corporate governance standards and firm performance.
6	Johnson *et al.* (2000)	He referred to the Asian financial crisis of the late 1990s and found that corporate governance was extremely relevant, and that there was a flight-to-quality among firms during this period.

7	Mitton (2002)	Used firm-level data of 398 listed companies from Indonesia, Korea, Malaysia, Philippines and Thailand and documented that the firm-level differences in the variables related to corporate governance had a strong impact on firm performance during the Asian financial crisis.
8	Cornettetal (2009) and Vahamaa (2011)	Found that firms with better internal corporate governance tend to have higher rates of return and are more profitable, respectively.
9	Sukamulja (2004)	Used 52 listed companies in Indonesia Stock Exchanges and found no significant effect of GCG to firm value in the profitability, age and size of the company.
10	Randy and Juniarti (2013)	Found that GCG measured GCG score has significant effect to the firm value.

2.9. Research Hypothesis

Stewardship theory had assumption that every man is essentially trustworthy, able to act in good faith in the interest of others with integrity and honesty (Donaldson and Davis 1988). But this view is distracted with the emergence of agency theory which stated managers could not be trusted to do their job which of course is to maximize shareholder value (Tricker). Basically, the agent should follow the principal desires in operating the company but in fact, many agents have their own goal which exactly includes for their own benefit. This act trigger the agents to do the manipulation, embezzlement and fraud which hence suffer the investors. The separation power of the owner and the agent creates a problem named agency problem. This problem occured because there is a dominant position of the agent who operates and controls daily operation of the corporation. Sometimes they act beyond the limits and forget the ultimate purpose of maximizing shareholders value. This contradiction needs to be solved by the existence of GCG practices.

According to Forum for Corporate Governance in Indonesia (FCGI), corporate governance purposed to give value added for the stakeholders. Hence, the advantage will be easier to get additional share capital, reducing cost of capital, then improving business performance and firm market value. Sylvia Veronica Siregar (2017) in the book of *Corporate Governance in Developing and Emerging Markets* describes good corporate governance in Indonesia. It includes the importance of shareholders rights, board commissioners, auditors and internal audit quality, disclosures and transparency in corporate governance procedure.

The concept of good corporate governance emphasizing the importance of the right of shareholders to obtain information with true, accurate, and timely. Providing their rights properly will increase their prosperities and wealths. And it will increase their demand of buying shares which affect to the rising share prices in the market. Efendi (2015) stated, share prices showed firm value, if one increases, others will increase too. In other words, share price increases caused by one of the factor of the shareholders prosperity and it will be achieved by fulfilling their rights. Therefore, fulfilled shareholder rights, higher their prosperity, will rise corporate share prices and the firm value.

Egon Zehnder International (in FCGI 2006) stated, board commissioners is the essence of the practice of Corporate Governance. They tasked to guarantee the execution of corporate strategy, management supervise, and controlling accountability. It is the center of endurance and success of the corporation. Other argument from Young (1998) argued, role of the board of commissioners is matter in improving company performance by pressing the manipulation of earnings and provide assurance on the proper information about the company's operations. GCG should be supported from the higher level that is the board of commissioners to increase the effectivity hence will increase firm value.

Other factor to increase the firm value is the quality of the auditors. A corporate will have less chance for the occurrence of fraud with an active and independent auditors both in audit committee and internal auditor (Beasley et al., 2000; Abbott et al., 2000, McMullen, 1996). Audit committee has the important role in accompanying commissioners in controlling financial activity. Having an effective audit committee will put forward financial disclosure and transparency which will improving firm value.

Hence, information disclosure and transparency may mitigate some of the agency problems faced by the firms. Shareholders will be more informed and information gap between the shareholders and the managers can be reduced. Investors will perceive lower investment risk that would lead to a higher firm value (Siagian, et. al., 2013).

Study of Klein (2002) and Chtourou et al. (2001) argued the company which have proportion of independent board of commissioner will impact the firm performance. Siallagan dan Machfoedz (2006) result a positive impact between independent commissioners and firm value. Sam’ani (2008) argued that audit committee has significant role in increasing financial report credibility and therefore creating a proper controlling system and the practice of good corporate governance.

A study from Klapper and Love (2002) find evidence that corporate governance is positively related to operating performance and market value. But oppositely, a research from Dwarachandra (2009) argued there is no significant impact to the firm performance nor the firm value. Ramadhani (2009) follows the disagreement that good corporate governance will be beneficial in the long-term period.

Based on the framework above a hypothesis is constructed :

H : Good Corporate Governance has positive impact on the firm market value