CHAPTER 2

THEORETICAL FRAMEWORK AND HYPOTHESIS DEVELOPMENT

2.1. Corporate Governance

2.1.1. Definition of Corporate Governance and Agency Theory

According to Jensen and Meckling (1976) agency relationship is a contact under which one or more persons (the principal(s)) engage another person (the agent) to perform some service on their behalf which involves delegating some decision making authority to the agent. If both parties to the relationship are utility miximizers, ther is good reason to believe that the agent will not always act in the best interests of the principal. This things will cause the conflict of interest between pricipal and agent by which it is called as agency problem.

Agency theory is a theory governing the relationship between a principal and an agent, where one party (the principal) delegates a job to the other (the agent). Agency theory tries to explain the relationship of contract mechanism (Jensen and Meckling, 1976). The principal has to provide funds and other important resources that needed in order to support the operations of the company, while the agent, as the manager of the company, is obliged to manage the company. The principal may not verify that the agent has performed and taken the appropriate policies to the principal's interest. Agency theory is highly considerate for solving problems in which the principal and the agent may prefer different actions due to different risk preferences. Managers' and stakeholders' different interests may result in agency problems or agency conflicts (Wahyudin and Solikhah, 2017).

Jensen and Meckling also stated that since the relationship between the stockholders and the managers of a corporation fits the definition of a pure agency relationship, it should come as no surprise to discover that the issues associated with the "separation of ownership and control" in the modern diffuse ownership corporation are intimately associatd with the general problem of agency. The separation between ownership with corporate control or agency problem results the conflict of interest, which this problem has may cause the ineffevective and inefficient in company performance includes decision making process. Management becomes vaguely in their performance because of conflict of interest that will led them to perform not in optimal form. Corporate governance is primarily concerned with finding a solution to the principal-agent problem. The principal, being the finance provider, 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 (Ehikioya, 2009).

The principal can limit the divergence from the interest that incurred between principal and the agent by establishing appropriate incentives for the agent and by incurring monitoring costs designed to limit the aberrant activities of the agent. In addition in some situations it will pay the agent to expand resources (bonding costs) to guarantee that he will not take certain actions which would harm the principal or to ensure that the principal will be compensated if he does take such actions. However it is generally impossible for the principle or the agent at zero cost to ensure that the agent will make optimal decisions from the principal's viewpoint. In the most agency relationships the principal and the agent will incur positive monitoring and bonding costs, and in addition there wil be some divergence between the agent's decisions and those decisions which would maximize the welfare of the principal. The money equivalent of the reduction in welfare experienced by the principal as a result of this divergence is also a cost of the agency relationship, and it refers to "residual costs" (Jensen and Meckling, 1976). They also define the agency costs as the sum of the monitoring expenditures by the principal, the bonding expenditures by the agent and the residual loss.

Corporate Governance recently has become one important issue that expected to be a great help company to face the agency conflicts on the company. It is also demanded as one of many solution to guide company in order to increase the financial and non-financial performance of the company. According to UK Corporate Governance Code that was introduced by Cadbury Committee in 1992, corporate governance is the system by which companied are directed and controlled. Boards of directors are responsible for the governance of their companies. The shareholders' role in governance is to appoint the directors and the auditors and to satisfy themselves that an appropriate governance structure is in place. The responsibilities of the board include setting the company's strategic aims, providing the leadership to put them into affect, supervising the management of the business and reporting to shareholders on their stewardship. The board's actions are subject to laws, regulations and shareholders in general meeting (FRC, 2010).

The Organisation of Economic Co-operation and Development (1999) (OECD) (Josephine *et al.*, 2015) in defines corporate governance as the machanism or the system by which business and organizations are directed and controlled. The OECD (1999) indicates that the adoption of good corporate practices has the ability to increase and restore shareholder confidence as well as economic efficiency and growth (OECD, 2004). Another definition stated that corporate governance is a set of mechanisms that aims to direct managerial decisions and helps improve the firms' performance (Jarboui *et al.*, 2015), while Vintila and Ghergina (2012) emphasized the fact that corporate governance mechanisms have the ability to mitigate the agency problem by aligning the interests of managers and directors with those of the shareholders.

Because of its impact to company, corporate governance becomes demanded almost in every sector and also becomes one of the important pillars in the company. As a result, stakeholders have begun to realize the impotance of good corporate governance practices in protecting their interests (Josephine *et al*, 2015). Furthermore, when Indonesian suffered the prolonged crisis many company around this country demand a better governance as a way to return to company's best condition. At that time financial performance of company decreased drastically, even monetary value weaken.

2.1.2. Principles of Good Corporate Governance

In Indonesia, Code of Good Corporate Governance is issued by the National Committee of Corporate Governance in year 2006. This Code of Good Corporate Governance includes five principles that must be performed by company, which are:

a. Transparency

Transparency means that company have to be able to provide a material and relevant information that easy to be accessed and understanable. Company is alo expected to be more initiative in disclosing their information that not only required by the regulation but also every important information that are needed by the stakeholders in decision making process. Those information are required to be provided timely or easy and able to be accessed when in need.

b. Accountability

Company have to be responsible to their performance transparently and reasonable. Therefore, company have to be properly managed, meeasurable and in accordance with the interests of company and still concern with the interest of shareholders and other stakeholders.

c. Responsibility

Company have to obey the regulations which is set by the government, company also have to perform the responsibility to society and environment to keep the continuity of business.

d. Independency

In order to keep the principles of Good Corporate Governance performed well, company must be managed profesionally and independently. Company also have to be managed without conflict of interest and influence or pressure from any party that is not in accordance with regulations and law.

e. Fairness

In doing the activities, company have to be able to recognize the interests of shareholders and stakeholders based on the principles of fairness and equality. Fairness also means that company must protect and pay attention to shareholders and stakeholders rights.

The basic principles of corporate governance provide advantages as the statement of each principle. As the advantage, it encourages the achievement of sustainability of company that is based on the principles of transparency, accountability, respomsibility, independence, and fairness. This advantage will lead stakeholders to pay more attention and also trust. With more trusts of stakeholders, managers and directors are tend to perform better. Also every decision that will be made are full of consideration of making company run well. As the result, firm performance will be increased. As it is recorded in the annual report, this will lead company to have a good perception not only from shareholders but also from the market. Investors are tend to put more interest in a company with not only better financial performance, but also good governance. As a economy entity, generally a company has short-term and long-term objectives. The short-term objective leads company to generate maximum profit with availabe profit, while the long-term objective is to maximizing the firm value (Ikbal *et al.,* 2011). Firm value is important to a company, because it reflects the firm performance that could affect market perception to the company (Meythi, *et al 2014).* Corporate governance is a term often used to explain the processes and structures used to direct and manage the business activities of a company in order to enhance its shareholdes' wealth (Mustapha and Ahmad, 2011).

2.1.3. Objectives and Advantages of Corporate Governance Implementation

Corporate Governance objective is to provide transparency to stakeholders by encouraging full disclosure of transactions on company accounts. Full disclosure includes compliance with the regulations and disclosing any important information to the shareholders. In the Code Corporate Governance that issued by KNKG, there are severals objectives and benefits that provided by implementing corporate governance.

- Encourage the achievement of sustainability of company that is based on the principles of transparency, accountability, respomsibility, independence, and fairness.
- Encourage empowerment and independence function within company, such as the Board of Commissioners, Directors, and General Meeting of Shareholders.

- Encourage the shareholders, members of the Board of Commissioners and Board Directors to make decisions and execute actions based on high moral values and adherence to laws and regulations.
- Encourage awareness and corporate social responsibility towards society and the environment, especially around the company.
- Optimizing value of the company to the shareholders with the consideration of the other stakeholders right.
- Increase the competitiveness of company from the national to global competition that will results in the increasing the investment flow and continuous national economic growth.

2.1.4. Corporate Governance Mechanism

2.1.4.1 Board Size

The board of directors plays a pivotal role in governance of widely hels corporations. At least in theory, the board of directors is one of the most important corporate governance mechanisms ensuring that managers pursue the interests of shareholders. Its task is to monitor, discipline, and remove ineffective management teams (Beiner *et al.,* 2004). According to Lipton and Lorsch (1992) and Jensen (1993) (in Isik and Ince, 2016) it is widely recognized that the board size is a crucial internal mechanism of corporate governance and plays a major role in firm’s management. For this reason, board size and its impact on firm financial performance is one of the most argued issues in corporate governance. The agency theory contends that superior firm financial performance may be associated with smaller board size. Compared to larger boards, smaller boards are less likely to have difficulty in coordinating and communicating. Furthermore, a smaller board is probably more effective at monitoring management's activities because it cannot be easily influenced by the CEO and thus smaller board size may cause better firm financial performance.

Isik and Ince (2016) also stated that a well governed firm is expected to have better performance and rational decisions of the board of directors make an important contribution to the governance. According to Fama (1980) (in Isik and Ince, 2016) the board of directors make decisions that are essential to the firm's performance. It is regarded as an integral part of internal governance mechanisms through which decisionsand actions of managers can be monitored.

2.1.4.2 Board Independency

According to Martsila and Meiranto (2013) the independency in board of commissioners is necessary in a purpose of mantaining the integrity that important to assuring the controlling and monitoring functions are worked properly. The participation of independent commissioners is designed to improve the ability of company in order to protect itself from any harmful threats. Mehran (1994) (in Martsila and Meiranto, 2013) stated that the existence of independent commissioners, the interests of shareholders include the majority and minority will not be abandoned because of the independent commissioners are act neutral and independent regarding to any decision that made by the managers. Therefore, with the neutrality of independent commissioners, stakeholders are expecting fair treatment that in turn will increase the trust of stakeholders. This would result in the increasing of firm performance as a whole, that also possible for a firm to mantain the perception of shareholders and potential investors.

2.1.4.3 Managerial Ownership

According to Jensen and Meckling (1976) (in Martsila and Meiranto, 2013) the higher percentage of managerial ownership will reduce the possibility of management to optimize the use of resource and also reduce the agency cost that incurred as a result of difference in interests. This is possible to happen because of the managers who has the involvement in the company through managerial ownership will have sense of belonging that therefore managers are tend to be more careful in making any decisions. Managers will alse face the consequences of the decisions that are made, because of it manager are expected to perform better. Hence, company with managerial ownership are expected to have better performance that considering manager as the owner will provide extra attention to any decision that were made.

2.1.4.4 Institutional Ownership

According to Budiman (2015), institutional investors tend to influence corporate governance process and are more efficient than indibidual investor. Increased institutionalization seems to improve the efficiency of governance role in capital market. Higher institutional ownership is associated with significantly better stock price based on Bushee (1998) (in Budiman, 2015). Shleifer and Vishny (1986) (in Navissi and Naiker, 2006) argue that the pressure of large institutional investors will have a positive effect on the market value of the firm because of the more effective monitoring. The prediction that large institutional investors have a positive influence on the value of the firm arises from the assumption that these investors have an incentive to and can efficiently monitor insiders.

2.2. Firm Value

Firm value is a value that achieved by a company as an image of society's trust on the company after a period of time since the company is established (Noerirawan, 2012). Firm value is necessary to a company because of its impact to the shareholders' wealth. Depending on its condition, shareholders' wealth will increase if the firm value is getting better. According to Fama (1978) in Sianturi (2015) a firm value can be reflected through company's shares price. In other word firm value is the perception of investors and potential investors to the success of the company that often related to the share price of company. The higher shares price, the higher firm value will be, and these condition will encourage market trust on the company. Maximizing firm value is necessary to company, because with maximizing the firm value company will also maximize the main objective of company. The increasing in firm value is an achievement of company that suited with the owners intention, therefore it will possibly increase the owners wealth. There are several ways to measure dirm performance. Those measurements are as follows:

1. Price to Book Ratio

Companies use the price to book ratio to compare a firm's market to book value by dividing price per share by book value per share. According to Investopedia, investors find the Price to Book Value ratio useful because the book value of equity provides a reletively stable that can easily compared to the market price. But on the other hand when the book value become negative for a long series of negative earnings, it will make Price to Book value ratio useless for relative vauation.

2. Price Earings Ratio

The price earnings ratio is the ratio for valuing company that measures its current share price relative to its per-share earnings. This ratio needs information of earnings per share information to calculate the value of it. In general, a high Price Earnings ratio suggests that investors are expecting higher earnings growth in the future compared to companies with lower price earning ratio. A low price earnings ratio can indicate either that a company may currently be undervalued or that the company is doing exceptionally well relative to its past trends. Company with losing trend will surely have no price to earnings ratio. This condition is categorized as the limitation of price earnings ratio as it may not be functioned in a company without earnings.

3. Tobin's Q

The tobin's q ratio is a ratio devised by James Tobin of Yale University, Nobel laureate in economics, who hypothesized that the combined market value of all the companies on the stock market should be about equal to their replacement costs. If the ratio is greater than 1, then the maret value is greater than the value of the company's recorded assets. This suggests that the market value reflects some unmeasured or unrecorded assets of the company. High tobin's q value encourage companies to invest more in capital because they are "worth" more than the price they paid for them. On the other hand, if tobin's q is less than 1, the market value is less than the recorded value of the assets of the ompany. This suggests that the market may undervaluing the company.

2.3. Corporate Governance and Financial Reporting

As the corporate governance becomes demanded, useful and popular around companies in Indonesia, besides the effort of government by KNKG developed and mantained the code of corporate governance, in a regulation called "*Keputusan Ketua Badan Pengawas Pasar Modal dan Lembaga Keuangan Nomor: KEP-431/ BL/ 2012"* about the submission of financial report, it concerns about the corporate governance. On this regulation, there are several items in the list that should be reported and disclosed by the firm in order to improve the reporting quality that will result in better information for the user of the finacial statements. With better corporate governance, it becomes possible to a company to have better financial reporting. More transparency may mitigate some of the agency problems that faceb by the company. Shareholders will be more informed and the information gap between the shareholders and the managers can be reduced (Siagian *et al*, 2013).

Better corporate governance tend to decrease any fraudulent activity that may harm the financial reporting. It is reasonable for a company to have a better financial reporting, as the corporate governance principles which are trasnparency, accountability, responsibility, independency and fairness is the important point of a good financial report.

2.4. Previous Research

Corporate governance have been used for more research in previous time. For the example in a research conducted with title “Corporate governance, reporting quality, and firm value: evidence from Indonesia” (Siagian *et al.*, 2013) have 125 firms that are traded in Jakarta Stock Exchange (JSX) in year 2003 and 2004 with using available Corporate Governance Index (CGI) data of the firm. This reasearh’s result is that it finds positive associations between corporate governance and different proxies of firm values. These findings suggest that firms that implement better corporate governance have higher values. The other research conducted by Padmanabha and Ramachandra (2017) with title “Corporate Governance and firm performance in Malaysia” finds that the performance of the firm is positively and significantly related with corporate governance measured by Malaysia Corporate Governance Index (MCGI) as the research first hypothesis. This research used sample of 113 listed companies inMalaysia. The study analyzes how the corporate governance framework affected firm performance in Malaysia with the help of self-developed corporate governance index (MCGI). This research also finds that corporate governance of sample firms shows marked improvements after implementation of Malaysian Code on Corporate Governance (MCCG) 2012 as compared to MCCG 2007.

The similar research that conducted by Arora and Sharma (2016) finds that by implementing good corporate governance practices it can possibly enhance the performance of the firm. This research was titled "Corporate governance and firm performance in developing countries: evidence from India". This study focuses on large number of companies covering 20 impoertant industries of Indian manufacturing sector for the period 2001-2010. There are several findings from this research. The first one, this research indicates that larger boards are associated with a greater depth of intellectual knowledge, which in turn helps improving ddecision-making and enhancing the performance. On the other side, whe results indicates that return on equity and profitability is not related to corporate governance indicators. The results also suggest that CEO duality is not related to any firm performance measures fo the sample firms. The outcomes of the analyses advocated that companies that comply with good corporated governance practices can expect to achieve higher accounting and market performance. It implies that good corporate governance practices lead to reduced agency costs. Hence, it is concluded that firms of the developing world can possibly enhance their performance by implementing good corporate governance practices.

2.5. Hypothesis Development

Corporate governance comprises a set of mechanism through which one entity can protect itself against expropriation by another. Installing a good corporate governance framework helps to reduce diverse costs, including agency conflicts. As in the background of this research and also previous research conducted, corporate governance is tend to make positive impact to company by which it provides more transparency that will lead stakeholders to put more trust. Then in this situation it is possible for a company to reduce the agency costs that occured because of the agency problem. Company in this case represented by management and board are tend to have more synergy with the owners. It is likely that company will put shareholders' interests as a big concern while at the same time the owners or shareholders will also take supportive action that might by necessary to help management. Also with better corporate governance, management is tend to perform legally and ethically, means that corporate governance will assure that there will be less fraudulent action that performed by management. Then as the results, corporate governance will increase management performance, reduce the agency cost, and also it is possible that the firm value will be influenced positively. In this research, it will focus on few corporate governance mechanism that suggested by previous study. Those are board size, board independency, managerial ownership and institutional ownership.

Boards of directors support managers in strategy formulation and implementation. Board members contribute to strategic decision-making by providing acces to resources upon which firms depend (Hillman and Dalziel, 2003)

As the previous study suggested, author examine the influence of the board of directors by analyzing its size and independence. Larger board can be more effective, as the monitoring managers can be divided over a greater number of individuals. Greater number of the board will also increase the amount on information and knowledge that shared internaly. These information or knowledge might be related to firm condition, industrial condition, and even firms position that will surely useful to board of commissioners in making effective decisions. Larger boards can also help firms to obtaining resources such as the amount of external funding. With more resources provided for consulting and monitoring roles, larger boards are more likely to strengthen the impact of corporate governance on firm value. Then author state the hypothesis on impact of board size as follows:

H1: Larger boards size positively influence the firm value.

Independency is necessary inside of the board of commissioners to preserve the integrity that will be helpful to asure that the controling function can be performed properly. With the existence of independent commissioners, then the interest of shareholders, the majority and even the minority will not be abandoned because the independent commissioners are more neutral to the decision that made by manager. Board independence affects firm performance through improved monitoring quality. This is mainly because independent (or external) directors are not involved in day-to-day management of the firm, which helps them to provide more objective recommendations. They do not have financial interests on the firms as much as internal directors (Coffey and Wang, 1998). They tend to take a more long-term perspective and pursue sutainable development (Johnson and Greening, 1999). Hence, we expect that independent directors pay more attention to companys long-term benefits.

H2: Board independency positively influence the firm value.

Jensen and Meckling (1976) stated that the larger amount of managerial ownership will reduce the tendency of management to optimize the use of resources and also reduce the agency cost as the impact of difference in interests. This things happen because managers are also the owner of the company, so that every decision will be made carefully and in proper way so that every consequences that can influence the manager could be avoided. Based on that description, hypotheses that can be formulated is:

H3: Managerial Ownership positively influence the firm value.

Institutional Ownership tend to influence corporate governance process and are more efficient than individual investor. Increased institutionalizations seems to improve the efficiency of governance role in capital market (Budiman, 2015). In general, institutional ownership will optimize the monitoring and controlling function on a firm (Permanasari, 2010). Company with large institutional ownership (more than 5%) indicating its ability to monitor management. Institutional investor will monitor the progress of the investments in companies and has a high degree of control to management. This minimizes the potential for management to commit fraud, so it can align management interests and the interests of stakeholder to improve company performance (Lim, 2011). Controlling and monitoring action from institution will also minimizing fraudulent activities from management. With this maximization of monitoring and controlling would possibly increase the performance of firm that will lead company to have a better market value.

H4: Institutional ownership positively influence firm value.