CHAPTER 1

INTRODUCTION

1.1 Background of the Research

Corporate governance is a set of processes, customs, policies, laws, and institutions affecting the way a corporation is directed, administered or controlled. Corporate governance also includes the relationships among the many stakeholders involved and the goals for which the corporation is governed. Issues on Corporate Governance started in Indonesia around 1998 when Indonesia experienced a prolonged crisis. Many parties say the length of process recovery in Indonesia caused by poor corporate governance adopted by the company in Indonesia. Since then, both the government and investors started give attention in corporate governance practices.

The main characteristic of weak corporate governance is the existence of self-interested actions by ignoring the interests of investors. It causes the collapse of investor expectations about return on the investment that they have invested. It happened because the management is concerned with its own interests (agency problem). Jensen and Meckling (1976) describe the agency relationship as a relationship arising because of the contract agreed between the principal and agent. In this case the principals represented by the investor or shareholder while the agent is represented by the management. Principal uses agents to perform services on the interests of principals. In fact, both parties are equally having an interest to maximize the welfare of each, so there is the possibility that agents do not always act in accordance with the interests of principals.

The essence of corporate governance is to increase company performance through monitoring management’s performance and accountability of management to stakeholders based on existing regulations. In Indonesia, Code of Good Corporate Governance (GCG) issued by the National Committee on Corporate Governance determines five principles that must be performed by each company. Transparency is ability to provide relevant and material information that is easily accessible and understandable to stakeholders. Accountability is ability to set the way for the company's interests in line with interests of shareholders and other stakeholders. Responsibility is ability to comply with laws and regulations and fulfill responsibilities to the community and the environment. Independency is a condition where no single part of the company is too dominating and there is no intervention from other parties. Fairness is a condition to fulfill the rights of stakeholders arising under the agreement and applicable laws and regulations.

According to Tjager et al. (2003) (in Agoes and Ardana 2009), the reason why implementation of good corporate governance is useful are: (1) based on a survey conducted by McKinsey & Company shows that more institutional investors put trust in companies in Asia that has implemented GCG , (2) based on the analysis, there were indications of linkages between the financial crisis and the prolonged crisis in Asia with the weak corporate governance, (3) the globalization of market including the liberalization of financial markets and capital markets requires companies to implement GCG, (4) even if the GCG is not a solution to emerge from the crisis, the system can be the basis for the development of new rate system that is more suitable with the current business environment, and (5) in theory, the practice of GCG can enhance company value.

This study aimed to investigate the effect of corporate governance on company’s performance. According to Berghe and Ridder (1999), linking the performance of companies with good governance is not easy to do. On the other hand, Berghe and Ridder (1999) stated that the company has a weak achievement caused by poor governance. The other research by Gompers, et al (2003) found that there was a positive relationship between the index of corporate governance with long-term corporate performance.

Based on the 5 principles of GCG, this study uses 4 variables which are the managerial ownership, institutional ownership, the size of the board director, and the proportion of independent commissioners to corporate performance. Mas Achmad Daniri (2005), mentioned that the principle of transparency can be associated in the managerial ownership, responsibility associated in the size of board directors, accountability and independency is associated in the independent commissioners, and the principle of fairness is associated in the institutional ownership. Company’s financial performance can be associated with the ratio of Return on Equity (ROE).

According to Jensen and Meckling (1976), managerial ownership and institutional ownership are the two main corporate governance mechanisms that help control agency problems. Managerial ownership is the ownership of shares by the company management as measured by the percentage of shares owned by management (Sujono and Soebiantoro, 2007). According Itturiaga and Sanz (2000) managerial ownership structure can be explained from two perspectives namely the agency approach, and the asymmetric information approach. Agency approach considers the structure of managerial ownership as a tool to reduce the agency conflict between the shareholders and the company. Asymmetric information approach is looking at mechanisms of managerial ownership structure as a way to reduce the imbalance between insider and outsider information through disclosure in capital markets.

Gunarsih (2004) stated that managerial ownership is one mechanism that can be used so that managers conduct activities in accordance with the interests of company owners. Managers will be motivated to improve its performance which is also the desire of shareholders. Managerial stock ownership will help to integrate the interests between managers and shareholders, so the manager can feel directly benefit from decisions taken and were also bear the losses as a consequence of making the wrong decision.

Concentrated ownership by the institution will facilitate the control of the company, so it will have an impact on improving company performance. Mamduh (2003) (in Putri 2006) stated that the higher institutional ownership, the better performance of the company because it has the ability to control the performance of the company. Husnan (2001) found that companies whose ownership is more spread out can give greater rewards to management compared to more concentrated corporate ownership.

Companies with large institutional ownership (more than 5%) indicating its ability to monitor management. Institutional investors 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 other stakeholders to improve company performance.

Board size of directors refers to the total number of directors in a company (Abdullah 2004; Hermalin and Weusbach 1991). Within the corporate governance literature, studies have examined the effect of board size on company's performance (Bhagat and Black 1996; Chaganti et al. 1985; Yermack 1996; Zahra and Pearc, 1989). There are studies that have shown increases in board size would negatively affect company's performance (Bhagat and Black 1996; Yermack 1996; Zahra and Pearce 1989). These studies' findings are consistent to the argument of Jensen (1993) states that the increase in group size would result to a less effective performance due to the overwhelming problems in coordination and process. However, there are studies conclude that increases in board size improve company's performance (Eisenberg et al. 1998; Lanser 1969). Other studies have found no relationship between board size and performance (Van Ees et al. 2003).

GCG needs a mechanism that can provide protection for shareholders to supervise management's performance as the party running the company. However, shareholders can not be any time supervises management's performance. Hence a company needs a mechanism of good corporate governance so that every decision taken by the management does not ignore the interests of shareholders. One of such mechanism is the presence of an independent board of commissioners.

This is supported by the presence of Bapepam Rule No. IA, General Provisions Registration of Securities on the exchange letter C-1, which in the framework of the implementation of proper management. Listed companies are required to have an independent Commissioner whose number is proportional to the number of shares owned by non-controlling shareholders with the provision of an independent commissioner at least 30% (thirty percent) of the total number of commissioners. Weisbach (1998) mentioned that the number of independent members of the board of commissioners has a negative relationship with CEO turnover, this is in line with the Monks (2001) (in Noventri 2007) which mentions that the company that well governed is shown by the number of independent commissioner on the board of commissioners.

According to Mas Achmad Daniri (2005), an ideal member of the Board of Commissioners are (1) individuals who can be trusted by the shareholders; (2) have integrity and dedication; (3) understanding the problems of corporate management; (4) has adequate knowledge in the field of business enterprise; (5) providing sufficient time to carry out their duties; (6) are able to understand and care about the interests of shareholders and all stakeholders in the company; (7) capable of making decisions based on good reasoning; (8) have the education; (9) professional experience; (10) extensive relationships that are beneficial to the company; (11) able to translate their knowledge and experience into solutions that can be implemented by the company. Monks (2001) in Noventri (2007) mention the company that well managed is shown by the number of independent commissioner on the board of commissioners.

Van Horne (1995) (in Indriastiti 2009) states that in order to evaluate the financial condition and performance of the company, financial analysis requires a certain size. The higher the ROE indicated the more efficient company use their capital to generate profit. With the huge profits it is reflected that the company has a good performance, thus attracting investors to invest its own shares.

Several previous studies have tried to evaluate the effects of good corporate governance variables on company performance. But these studies have different results in the influence analysis of good corporate governance on company performance. Based on the description above, this study took the title: "THE EFFECT OF GOOD CORPORATE GOVERNANCE ON COMPANY

PERFORMANCE OF LISTED MANUFACTURING COMPANIES IN INDONESIA STOCK EXCHANGE DURING THE PERIOD 2007 -2009 ".

1.2 Research Problem

Based on the background of problems that described above, it can be identified that these research problem want to be investigated (1) Does managerial ownership effect company's performance? (2). Does institutional ownership effect company's performance? (3). Does the size of the board of director effect company's performance? (4). Does proportion of independent board of commissioner effect company's performance?

1.3 Objectives and Benefits

- Objectives of the research

The purpose of the research is to determine whether managerial ownership, institutional ownership, the size of board directors and the proportion of independent board of commissioners influence company's performance.

- Benefits of the Research

The results of this study are expected to benefit:

1. For academics, to add knowledge and resources for further research related to the influence of corporate governance on company performance.
2. For investors, to provide information for investors to know some variables that can affect company's performance.
3. For Company, to provide information regarding the effect of the implementation of good corporate governance to improve the financial

performance of company. That information is a feedback to the company for the implementation of good corporate governance that has been done.

1.4 Systematical Discussion

The systematical discussions are as the following:

CHAPTER 1: Introduction of the entire contents which is an overview of research and issues raised. This chapter contains the background of the problem, research problems, objectives and benefits of research, and systematical discussions

CHAPTER 2: Literature review outlines the theoretical basis and previous research to be used as a reference for data analysis in this study. This chapter also describes the theoretical framework.

CHAPTER 3: Methods Research describes the selection of research design, selection of research approaches, methods of data collection, data analysis methods, and the selection of research settings.

CHAPTER 4: Results and analysis will discuss the impact of good corporate governance to company performance.

CHAPTER 5: Discussion and conclusion contains the conclusions of this research that to answer research questions as well as limitations of the study and suggestions given for further research.