CHAPTER 2

GOOD CORPORATE GOVERNANCE & HYPOTHESIS DEVELOPMENT

2.1 Corporate Governance

2.1.1 Definition of Corporate Governance

Corporate governance arises because there is a separation between ownership with corporate control, or known as agency problems. Agency problems between owners in conjunction with managers is how hard the owners in ensuring that the funds invested are not taken over or invested in projects that are not profitable. Corporate governance is needed to reduce agency problems between owners and managers. Corporate governance describes the relationship between the various participants in companies that determine the direction of the company's performance.

Some of the concepts about the corporate governance, among others, proposed by Shleifer and Vishny (1997) who stated corporate governance relating to the manner or mechanism to convince the owners to obtain an appropriate return to the investment that have been planted. Iskandar, et al (1999) suggests that corporate governance refers to the framework of rules and regulations that allow stakeholders to make the company maximizes value and to obtain the return. In addition, corporate governance is a tool to ensure directors and managers to act in the best interests of investors (Prowson, 1998).

The separation of ownership by the principal with control by agent in an organization tends to lead to agency conflicts between principals and agents. Jensen and Meckling (1976), Watts and Zimmerman (1986) states that financial statements prepared by accounting numbers are expected to minimize conflicts among the parties concerned. The financial statements reported by the agent as a form of accountability for its performance so that principals can assess, measure and monitor the extent to which these agent work to improve their welfare, and provide compensation to the agent.

Kaen (2003) stated corporate governance is essentially a matter of who should control the course of corporate activity and why it should be to control the course of corporate activity. What is meant by "who" are the shareholders, while the "why" is because of the relationship between shareholders with various stakeholders on the company.

2.1.2 Principles of Good Corporate Governance

In Indonesia, Code of Good Corporate Governance (2006) issued by the National Committee on Corporate Governance, there are five principles that must be performed by each company, namely:

a. Transparency

Transparency could be interpreted as a disclosure of information, both in the decision making process as well as in revealing material and relevant information about the company. Investor confidence depends on the quality of the information submitted the company. According to capital market regulations in

Indonesia, which is material and relevant information is information that could affect the company's stock price fluctuations, or which significantly affect the risk and the business prospects of the company concerned. In realizing this transparency alone, the company must provide information that is relevant, accurate, and timely information to the various parties concerned with these companies, and investors should be able to access important company information easily when needed.

b. Accountability

The principle of accountability requires that the company can reasonably account for its performance. The essence of accountability is the clarity of function, structure, organ systems and accountability of the company so that company management is effectively implemented. If the principle of accountability is applied effectively, then there is clarity of functions, rights, duties, authority, and responsibility among shareholders, the Board of Commissioners, and Directors.

c. Responsibility

Responsibility is the compliance in the management of the company towards a healthy corporate principles and applicable legislation. The application of this principle is expected to make the companies realize that in its operations often give negative external impacts that must be borne by society so that there should be accountability of companies to cope. In addition, through the principle of responsibility is also expected to assist the government's role in reducing inequalities of income and employment opportunities in the segment of society that has not received the benefits of market mechanisms.

d. Independency

The independence is a condition where the company is professionally managed without conflicts of interest and influence or pressure from any party that is not in accordance with applicable laws and regulations and the principles of a healthy corporation. The independence is particularly important in the decision making process. Loss of independence in decision-making process will eliminate the objectivity in decision making.

e. Fairness

Fairness is simply defined as a fair and equal treatment in fulfilling stakeholders' rights arising under the agreement and applicable laws and regulations. Fairness also includes a clear sign of investor rights, legal system and enforcement of regulations to protect the rights of investors, especially minority shareholders of the various forms of cheating. Fairness is expected to make the entire company's assets are managed properly and carefully, so there is protection of the interests of shareholders fairly.

Meanwhile, according to National Committee on Governance (KNKG) 2006, each company must ensure that the principles of good corporate governance applied to every aspect of business and in all ranks of the company. The principle of good corporate governance namely transparency, accountability, responsibility, independence and fairness and equality are necessary to achieve business continuity (sustainability) of the company with respect to stakeholders.

2.1.3 Objectives and Benefits of Implementation of Good Corporate Governance

The main objective of good corporate governance is to provide adequate protection and fair treatment to shareholders and stakeholders, through increased shareholder value to the maximum (Suprayitno, et al., 2005). Good corporate governance is not merely an attempt to keep the company working according to rules and norms which are universally applicable, but also to gain investor confidence to invest in public companies. Code of Good Corporate Governance of the National Committee on Governance, states that good corporate governance is required in order to:

1. Encourage the achievement of sustainability of company that is based on the principles of transparency, accountability, responsibility, independence and fairness.
2. Encourage empowerment and independence of function within the company, such as the Board of Commissioners, Directors and General Meeting of Shareholders.
3. Encourages shareholders, members of the Board of Commissioners and Board of Directors to make decisions and execute actions based on high moral values and adherence to laws and regulations.
4. Encourage awareness and corporate social responsibility towards society and the environment, especially around the company.
5. Optimizing the corporate value for shareholders by considering the other stakeholders. Improving the competitiveness of companies nationally and internationally, thereby increasing confidence in the market that can encourage investment flows and sustain national economic growth.

2.2 Company performance

According to Admin and Zulfadin (2003) in the Cornelius (2007) performance of the company is an important thing to be achieved by any company, because the performance is a reflection of the company's ability to manage and allocate its resources. Performance of the company is the company's ability in explaining the operation (Payatma, 2001).

The purpose of performance evaluation is to motivate employees in achieving the organization's objectives and adhere to standards of behavior in the predetermined order to distinguish the desired outcomes and actions. Standards of behavior may be either a formal management policy or plan as outlined in the budget.

Performance evaluation by Sucipto (2003) in the Indriastiti (2009) used by managers for the following things:

- Manage the organization's operations effectively and efficiently through motivating employees.
- Helps managers in decision-making that concerned with employees such as promotions, transfers and dismissal.
- Provide employee training and development needs and to provide selection criteria and evaluation of employee training programs.
- Provide feedback to employees about how they assess the performance of their superiors.
- Provide a basis for assessing the performance of their distribution.

Financial ratios are the main tool for analyzing financial statements. There are two groups who consider the financial ratios are very useful. The first, consisting of managers who use it to measure and track the performance of the company all the time. Second, users of financial ratios include the analysts who are external to the company.

Here are some financial ratios used to measure company performance Ang (1997) in the Cornelius (2007) are:

1. Liquidity ratio.

The ratio that is shows the company's ability to meet short-term financial obligations on time, such as Cash Ratio, Quick Ratio, Current Ratio, Inventory Ratio.

2. Activity ratio.

The ratio that shows how resources have been used optimally, then by comparing the ratio of activity with industry standards, it is known the level of efficiency in the industrial company, such as Accounts Receivable Turnover, Inventory Turnover, Total Asset Turnover.

3. Profitability ratios.

Profitability ratios are ratios to measure how big the company's ability to earn profits well in conjunction with sales, assets and profits for their own capital. Profitability ratios are divided into six profitability ratios such as: Gross Profit Margin (GPM), Net Profit Margin (NPM), Operating Return on Assets (OPROA), Return on Assets (ROA), Return on Equity (ROE), Operating Ratio (OR).

4. Solvency ratio (Leverage).

Shows the proportion of financial leverage over the use of debt to finance its investment. Companies that do not have the leverage means using 100% own capital.

5. Market ratio.

This ratio indicates the company's important information that is expressed in the per-share basis.

According to Hastuti (2005), company performance is the result of many individual decisions made continuously by the management. Financial performance is one factor that shows the effectiveness and efficiency of an organization in achieving goals. Effectiveness is measured through the ability of management to choose an appropriate tool to achieve that goal. Efficient can be defined as the ratio between input and output.

2.3 Agency Theory

In order to understand the corporate governance perspective, it is used the basis of agency relationships and stewardship theory. Jensen and Meckling (1976) stated that the agency relationship is a contract between managers and investors. Conflict of interest between principals and agents due to the possibility of agents to act not in accordance with the interests of principals, leading to agency costs. As an agent, manager has morally responsible to optimize profits for the owners to obtain compensation in accordance with the contract. Thus there are two different interests in companies in which each party seeks to achieve or maintain the desired level of prosperity (Ali, 2002).

Eisenhardt (1989) in Darmawati (2005) uses three basic assumptions of human nature in order to explain the theory of agency, namely: (1) general human selfishness, (2) humans have a limited power of thought regarding the perception of the future, and (3) human always avoid the risks. Based on that assumption of human nature, manager as a human likely to act on opportunistic nature, this gives priority to own interests (Harris, 2004).

Stewardship theory is based on philosophical assumptions about human nature is that humans are basically trustworthy, able to act with full responsibility with integrity and honesty towards others. This is implicit in the nature of fiduciary relationships (trust) is desired by the shareholders. In other words, stewardship theory of management saw as the party can be trusted to act in the best possible for the public interest in general and shareholders in particular. (Daniri, 2005).

Corporate managers would be more aware of internal information and the company's prospects in the future than the shareholders. Therefore, managers should always give a signal about the condition of the company to the owner. The signal can be given by the manager through the disclosure of accounting information such as financial statements. Financial statement is very important for external users primarily because this group is in the greatest uncertainty (Ali, 2002).

An imbalance in control of information will trigger the emergence of a condition known as information asymmetry. Given the information asymmetry between management and owners will be offered an opportunity for managers to do earnings management. So it will mislead shareholders about the company's economic performance.

The financial statements are intended to be used by various parties, including the management company itself. However, the most concerned with the actual financial statements are the external users (excluding management). The financial statements are important to external users primarily because this group is in the greatest uncertainty (Ali, 2002). The internal users (the management) have direct contact with the entity or his company and know the events of significant events that occurred, so the level of reliance on accounting information is not for external users.

In this case the principal should obtain the information needed in assessing the results obtained from the agency business, but it turns out the information about the measure of success obtained by the principal is not entirely served by the agency. Consequently, information obtained by the principal is incomplete. So it still cannot explain the actual performance of agents in managing the wealth of the principal who has been entrusted to the agent.

As a result of information that is not balanced (asymmetry), it can cause two problems that caused the principal difficulty to monitor and control the actions of agents. According to Scott (2000), there are two kinds of asymmetry of information, namely:

1. Adverse selection, which is that managers and other people in usually know more about the state and the company's prospects than outside investors. And

facts that may affect the decisions to be taken by shareholders is not submitted the information to shareholders.

2. Moral hazard, namely that the activities carried out by a manager is not fully understood by shareholders and lenders. So that managers can take action outside the knowledge of shareholders in violation of the contract and the actual ethics or norms may not be worth doing.

Corporate governance is a concept based on agency theory, is expected to serve as a tool to give confidence to investors that they would receive a return on the funds they have invested. Corporate governance is concerned with how to make investors believe that managers will benefit them, convinced that the manager will not darken or invest in projects that are not favorable by investors.

2.4 Hypotheses Development and Previous Research

Fama and Jensen (1983) stated that the agency problems caused by the existence of that separate system of decision-making between management and the supervisors. Fuerst and Sok-Hyon (2000) states that various studies, including research by Jensen and Meckling (1976) and by Shleifer and Vishny (1997), suggests that the separation of ownership and the management to the company brings to the conditions under which managers will squander the wealth of corporate owners.

Agency Conflict itself is divided into two forms, that are: (1) the agency conflict between shareholders and managers. The cause of the conflict between managers with shareholders including the decision-making related to fundraising activities (financing decision) and decision making related to how the proceeds are invested, (2) the agency conflict between shareholders and creditors.

According to Zulhawati (2004) agency cost is the cost incurred by the company to reduce agency problems, which includes spending on monitoring, bonding, and Residual cost. Brigham and Daves (2004) quoted by Ummah (2005) define agency costs as the costs borne by shareholders to encourage managers to maximize long-term stock prices rather than act in their own interests.

There are several alternatives that can be used to reduce agency costs, among other things: (1) align management interests with shareholders by engaging managers to own shares of the company (insider ownership), (2) increase the dividend payout ratio, (3) increase the funding of debt, and (4) increasing institutional ownership. Furthermore, Jensen and Meckling (1976) in Nirwana (2005) show that ownership structure, financing decisions and dividend policy can be used to reduce agency costs that stem from agency problems.

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), while institutional ownership is ownership by the government, financial institutions, legal institutions, foreign institutions, and trust funds (Shien, et.al. 2006).

Corporate performance is the result of the company's operations. Operational activities in the financial statements are indicated by the achievement of net income. Profit is the difference between revenue and expenses. Therefore managers in managing the company will try to maximize revenue and pressing expenses. Activities referred to maximize revenue increased profitability, while pressing the expenses referred to increased efficiency. Company's performance would be better if the company's shares are owned by the manager. Managers are no longer as salaried professionals, but also as the owner of the company. A good performance of the company will have an impact on dividends to be received shareholders, since dividends are always based on current year's net income and net income is a measure of corporate performance. Managers who own shares the company will enjoy this dividend.

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. Increasing managerial ownership can be used as a way to overcome agency problems. Managers will be motivated to improve its performance which is also the desire of shareholders, Ross et. al (2004) in Putri (2006) states that the greater proportion of ownership in the company, the management tends to try harder for the interests of shareholders where the management itself.

H1: managerial ownership has a positive effect on company performance

Bathala et al., (1994) found that institutional ownership replaces managerial ownership to control agency cost. The greater ownership by financial institutions, the larger the voting power and urge financial institutions to oversee the management and consequently will give greater impetus to optimize the value of the company so that company performance will also increase. The existence of institutional ownership such as insurance companies, banks, investment companies and ownership by other institutions will promote a more optimal monitoring of management performance.

H2: institutional ownership has a positive effect on company performance

Fama (1980) in Faisal (2005) stated that the board is the main internal control mechanism that monitors the manager. Three characteristics that influence the monitoring are the size of the board of directors, the composition of the board of directors and leadership structure (Jensen, 1993) in Faisal (2005).

Shaw (1981), Jewel and Reitz (1981), Olson (1982), Galdstein (1984), Lipton and Lorsch (1992), Jensen and Meckling (1976) in Faisal (2005) stated that the large number of directors is less effective in monitoring management. This is supported by research conducted by Yermack (1996) and Eisenberg et al. (1998) in Faisal (2005) stated that the small number of the board of directors enhance corporate performance. According to Yermack (1996), Faisal (2005) the size of the board of directors would disturb the interests of shareholders. Singh et al. (2003) in Faisal (2005) stated that the small size of the board of directors, the more positively and significantly affect the efficiency of asset utilization but have a significant influence on the reduction of agency costs as measured by operating expenses. The larger the board the greater the burden of managerial discretion is happening. The costs caused by the large size of the board of directors, will affect the decline in revenue. Therefore a large board size negatively affects the company performance.

H3: size of the board directors has a negative effect on company performance

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.

The existence of an independent commissioner in companies expected to empower the commissioners to perform the task of monitoring independently and providing advice to directors who are expected to effectively improve the performance of the company. With the existence of one of the mechanisms of good corporate governance, it is hoped the monitoring of corporate managers can more effectively so as to improve company performance.

Based on Good Corporate Governance Guidelines, the composition or the number of independent commissioner is not specified in a certain amount but nevertheless the number or composition of an independent commissioner should ensure that supervisory mechanisms to effectively and in accordance with statutory regulations. The criteria set is one of the Independent Commissioner should have a background in accounting or finance. Although the Code of Good

Corporate Governance does not specify the number of Independent Commissioner, in Bapepam-LK, the Issuer or Public Company must have at least one independent commissioner while the Indonesia Stock Exchange requires that at least 30% of the Board of Commissioners is an independent commissioner.

Independent Commissioner in detail the criteria stipulated in Bapepam-LK, namely:

a. Originating from outside the Issuer or Public Company

b. Has no shares of the Issuer or Public Company either directly or indirectly

c. Has no affiliation with the Commissioners, Directors and Major Shareholders of the Issuer or Public Company

d. Has no business relationship with the Issuer or Public Company either directly or indirectly

H4: the proportion of independent commissioners has a positive effect on company performance