CHAPTER I

INTRODUCTION

1.1 Background

The development of globalization in various aspects caused each company must face global competition. The emergence of competitors from around the world will be a serious challenge for the company. To be able to maintain its survival and to keep achieving success, company must keep on developing. In order to keep on developing, company sometimes need to increase its capital. Additional capital can be sourced from equity and debt.

To obtain additional capital through debt, creditor will first evaluate the feasibility of the company to receive debt. Creditors will estimate the default risk in the firm. Default risk associated with the probability of company's inability to pay their debt obligations. To protect creditors from the default risk, the debt is usually followed by cost of debt. Cost of debt, which usually referred to the interest expenses, is cost that are given by the creditor to the company for the debt. Interest expense paid by the company to the creditors depends on the interest rate as agreed in the debt agreement (given by creditor based on the assessment of company's default risk). If a company's default risk is low, then the confidence of creditors to the company will be high so that the company can get a low interest rate. The opposite occurs if a company's default risk is high, the confidence of creditors to the company will be low so that the company will get a high interest rate.

On the other hand, in an open economy nowadays, the practice of good corporate governance is trusted can be an additional consideration for the creditor when giving interest rate. In 1999, The Organization for Economic Cooperation and Development (OECD) as stated in the "Principles of Corporate Governance" in Prasetyantoko (2008, 33) said:

> "Good corporate governance helps to ensure that corporations take into account the interests of a wide range of constituencies and that their boards are accountable to the company and the shareholders. This, in turn, helps to maintain the confidence of investors, both foreign and domestic and to attract more long-term capital"

Company with good corporate governance is believed can maximize the management of the company professionally, efficiently, and transparently. Transparency in the management of company can be a reference if debt received by the company is used appropriately and efficiently as possible to bring the financial progress. With this reference, lender can be assured that the debt given will be recovered properly thus will lower the default risk. In addition, the transparency of the management company can prevent opportunistic actions of some particular party.

As stated in CGPI Report 2009 (2010), the existence of good corporate governance arises since the case of Enron who did fraud in financial statements. Lack of good management within the company may harm the shareholders interest. Since then, the trust of investors or creditors against public companies declined. In Indonesia, the economic crisis in 1997-1999 that brought many companies to the losses and bankruptcy, have lowered the confidence level of both creditors and investors. To recover the economy and confidence level of both creditors and investors, Indonesia and IMF introduce the practice of good corporate governance.

According to Babic (2001) in Haryani et al. (2011), corporate governance mechanisms can be either internal mechanisms which are ownership structure, the board commissioner structure, executive compensation, multi-division business structure, or external mechanisms which are control of the market, institutional ownership, and the audit by external auditors. Meanwhile, Barnhart and Rosenstein (1998) divided corporate governance mechanism into two groups. First is the internal mechanisms, such as the composition of the board of directors / commissioners, managerial ownership, and executive compensation. The second is external mechanisms, such as control of the market and the level of debt financing. In this study, the measurement of good corporate governance implementation by the company can be proxy by several indicators such as independent commissioners, audit committee, institutional ownership, and managerial ownership.

The practice of good corporate governance in Indonesia raise questions whether its application really affects the confidence of creditors. Few studies have examined the effect of corporate governance on the cost of debt. Ashbaugh et al. (2006) proved that corporate governance positively related to the credit ratings. Thus will lower the cost of debt. This research is in line with research by Blom and Schauten (2006) that stated the practice of good corporate governance negatively related to the cost of debt. Companies with good corporate governance have a low risk, while companies with weak corporate governance have higher risk. This risk will affect the perception of the creditors on the company's ability to meet its financial obligations. It is clear that with a low risk, companies with strong corporate governance will be charged a low cost of debt. Meanwhile, companies with weak corporate governance have higher risk and will be charged a high cost of debt. These studies give different result to the research conducted by Susiwati (2009) which states the implementation of good corporate governance has no effect on the cost of debt, only the times interest earned and the return on assets that affect the cost of debt.

Based on the explanation above, the authors feel interested to make a research with a title: "The Effect of Corporate Governance on Companies' Cost of Debt"

1.2 Problem Formulation

1) Is there any effect of independent commissioners on companies' cost of debt?
2) Is there any effect of audit committee on companies' cost of debt?
3) Is there any effect of institutional ownership on companies' cost of debt?
4) Is there any effect of managerial ownership on companies' cost of debt?

1.3 Limitation of Problem

In this study, researcher limit the concept of research, which are:

1) The corporate governance is limited by using four proxies, which are board of independent commissioner, audit committee, institutional ownership, and managerial ownership.

2) The sample is limited by using only manufacturing companies listed on Indonesia Stock Exchange from 2009-2011.

1.4 Objectives of Research

1) To analyze the effect of independent commissioners on companies' cost of debt
2) To analyze the effect of audit committee on companies' cost of debt
3) To analyze the effect of institutional ownership on companies' cost of debt
4) To analyze the effect of managerial ownership on companies' cost of debt

1.5 Benefit of Research

1) For companies

   Through this study, the authors hope the company can more clearly see the effect of good corporate governance on cost of debt. By seeing this, hopefully company can evaluate and optimize the implementation of good corporate governance.

2) For other researchers

   For other researchers, the authors hope this study can add knowledge they need about good corporate governance and cost of debt. In addition, the authors hope this study can be a reference for further studies.

3) For authors

   Hopefully, this study can obtain a clear picture of its application not only theoretically but also practically as well as to add knowledge of the author.

1.6 Systematics of Writing

1) CHAPTER 1 – INTRODUCTION

In this chapter the author will explain the background of the title selection. The formulation of the problem and the limitation of the problem will also be explained in this chapter. Moreover, this chapter also contains benefits of research, research method that being used and the systematics of thesis writing that will show the sequence and relationship between chapters.

2) CHAPTER II – THEORITICAL FRAMEWORK

In this chapter the authors will discuss the theories related with this research and also review of relevant literature that can be used as basis and reference for this research. Review of relevant literature is also being used as reference to hypothesis formulation. Furthermore, theoretical framework will be presented to help readers to understand this research.

3) CHAPTER III - RESEARCH METHODOLOGY

This chapter describes all things that related with research methods that being used by author. This chapter will contain research population and sample, types and source of data, data collection method, variables both definition and the measurement, model of empirical research, and analysis method used.

4) CHAPTER IV - RESULT AND ANALYSIS

This chapter contains descriptive analysis of the data processing result, classical assumptions test analysis, and hypothesis test analysis. This analysis will be explained to support the conclusions of the study.

5) CHAPTER V - CONCLUSIONS AND SUGGESTIONS

This chapter is the latest chapter of the thesis, which contains the conclusions of the research, the limitation of research, and suggestions that is considered necessary.