CHAPTER I

INTRODUCTION

1.1 Research Background

Nowadays, global business environment is characterized by an increased competition of the corporate governance in protecting the shareholder's interests. Corporate governance deals with the ways investors assures themselves in getting return on investment (Topak, 2011).

Indonesia is a great example of an economy where the awareness towards the importance of good corporate governance principles such as transparency, accountability, responsibility, and fairness has increased dramatically since the 1997/1998 Asian financial crisis. There are two approaches that has been used to implement the good corporate governance in Indonesia which are ethic-based and regulatory. The method that has been chosen in Indonesia is the ethic-based approach which stressed the importance of a more sustainable and healthy long-term relationship with the stakeholders rather than just pursuing short-term profit. The development of good corporate governance has increased over the years as more and more listed companies introduced the corporate governance codes (Yap, 2012).

Solomon (2010) defines corporate governance as the system of checks and balances which are both internal and external to the companies, which ensures that companies discharge their accountability to all stakeholders, and act in a socially responsible way in all aspects of their business activities In the finance theory, the basic assumption is that the primary objective of the company is to maximize the stakeholder wealth, although in practice it is not necessarily the case which cause a conflict of interest between the owner or ‘principal’ and the managers ‘agent’. The case of relationship between the principal and agent is summarized as an agency theory. A conflict of interest may cause problems to arise, and one of it is the tendency to focus on the projects that provides high short-term profit rather maximization of shareholder wealth through long-term investment projects (Solomon, 2010).

Investors are increasingly attracted to companies with good corporate governance as companies adhering to corporate governance codes are viewed as less risky as they also conform to the demand of a greater socially responsible part of the corporations. Corporate governance scandals around the world had also cause the acceptance of the concept of good corporate governance too (Yap, 2012). The examples of those scandals are the collapse of Enron in 2002 and Parmalat in 2003. Those scandals shows how corporate governance is essential in successful business and social welfare (Solomon, 2010).

The importance of good corporate governance arises in a firm because of the separation between those who control the company and those who own the residual claims (Fooladi and Farhadi, 2011).

This research also has another aspect other than corporate governance mechanism which is capital structure. Capital structure can simply be referred as the source of financing or the equity and debt financing for the company. The source of financing can come from the relatively permanent equity capital or the more risky or temporary short-term financing source that is the use of debt or leverage. A company's financial stability and solvency risk depends on its financing source. Companies typically uses both debt and equity as its source of financing. From the shareholder's perspective, debt is the more preferred source of external financing although creditors are generally unwilling to provide financing without some sort of protection The capital structure of the company can help us determine the company's financial condition, results of operation, and future prospects (Subramanyam and Wild, 2009).

The relationship between capital structure and firm value have been extensively investigated in recent years as it is one of the important financial decisions for any business organizations (Ahmad et al., 2012).

Jensen and Meckling (1976) found that the amount of leverage in the firm's capital structure affects the conflicts between managers and shareholder's conflicts as mentioned about the agency theory and thus can alter the manager's behavior and decisions.

Firm performance is an important concept that is it relates to the way and manner in which the financial resources of the company are used to achieved the overall corporate objective of the company. It helps the organization in business and also create a great prospect for the future of the company (Yasser et al., 2011).

The performance of a company or firm is affected by many factors. The aspect of the firm performance that this research focused in is in terms of the financial performance of the company. This can be measured by using the Return on Equity or the ROE of the company. In this research, the main objective is to determine the relationship between the corporate governance components such as the of board size, board composition and audit committee, ownership concentration, institutional ownership, and the non-corporate governance component that is capital structure towards the firm's performance specifically the financial performance. Previous research such as Chaghadari (2011) in Malaysia has shown the relationship between corporate governance and the firm performance, although it is limited to the sample size that is relatively small. The research of Iorpev and Kwanum (2012) which is about the capital structure impact towards firm performance also shows relationship between the variables. Both corporate governance and capital structure is an important factor to be considered in determining the firm's performance. It was mentioned earlier that the basic assumption is that company's interest is to maximize the shareholder's wealth, and this are both the case in corporate governance and capital structure. This research will combine the two variables that are the corporate governance and capital structure and analyze the relationships and effects towards the financial performance of the firm.

Based on the explanations above, the writer decided to examine the influence of corporate governance mechanisms and capital structure towards the financial performance for the research.

1.2 Problem Formulation

Based on the background discussed above, the main problem of this research is in terms of finding the relationship between corporate governance mechanisms (board size, board composition, audit committee, ownership concentration, and institutional ownership) and capital structure (short-term debt to total asset, long-term debt to total asset, and total debt to equity) towards the financial performance (return on equity).

1. Does board of commissioner size influence the financial performance?
2. Does board of commissioner composition influence the financial performance?
3. Does audit committee size influence the financial performance?
4. Does ownership concentration influence the financial performance?
5. Does institutional ownership influence the financial performance?
6. Does short-term debt to total asset influence the financial performance?
7. Does long-term debt to total asset influence the financial performance?
8. Does total debt to equity influence the financial performance?

1.3 Purpose of the Research

The purpose of this research is to answer the problems formulated in this research that is to empirically test whether there is a relationship between corporate governance mechanisms and capital structure towards the financial performance. The purpose of this research is summarized as below

1. To obtain the empirical evidence of the influence of board of commissioner size towards financial performance.
2. To obtain the empirical evidence of the influence of board of commissioner composition towards financial performance.
3. To obtain the empirical evidence of the influence of audit committee size towards financial performance.
4. To obtain the empirical evidence of the influence of ownership concentration towards financial performance.
5. To obtain the empirical evidence of the influence of institutional ownership towards financial performance.
6. To obtain the empirical evidence of the influence short-term debt to total asset towards financial performance.
7. To obtain the empirical evidence of the influence of long-term debt to total asset towards financial performance.
8. To obtain the empirical evidence of the influence of total debt to equity towards financial performance

1.4 Advantages of the Research

This research aims to give contribution to the followings:

1. For academic purposes. Give evidence in regards of the impact of corporate governance mechanisms and capital structure towards firm performance. This research is intended to be used as a source of reference

for further researches that are related to the impact of corporate governance and capital structure towards the financial performance.

2. For investors. As a means of consideration and guidelines in making investing judgment to the companies listed in BEI.

1.5 Problem Limitations

This research focus on the relationship two independent variables which are corporate governance and capital structure towards the firm's financial performance. The followings are the problem restrictions of this research which are:

1. The corporate governance aspect of board of commissioner size, board of commissioner composition, audit committee size, ownership concentration, and institutional ownership is used as the main focus in the corporate governance variable.
2. The capital structure aspect of the research will be focusing on the debt management ratios which are short-term debt to total asset ratio, long-term debt to total asset ratio, and total debt to equity ratio.
3. The firm performance is measured by using the Return on Equity (ROE) of the firm which is the financial aspect of the firm performance rather than the non-financial performance of the firm.

4. In terms of data collection, the research uses the data that is available from the companies that are listed in BEI specifically in the manufacturing sector.

1.6 Writing Scheme

This research will be presented in a total of five chapters in the following systematic order:

CHAPTER I INTRODUCTION

The first chapter of the research will give a general introduction of the research which will include the research background, problem formulation, purpose of the research, advantages of the research, problem restriction, and the writing scheme which will show how the research will be presented in each chapters.

CHAPTER II THEORETICAL BACKGROUND AND HYPOTHESES DEVELOPMENT

The second chapter of the research will give the theoretical understanding on the topic, and also provide relevant literatures to the problem formulated in the research. The theories will be gathered from references such as textbooks and journals related to the topic. This chapter will also explain the hypotheses developed in this research based on previous researches.

CHAPTER III RESEARCH METHODOLOGY

The third chapter of the research will show the method of gathering data from samples and population and how those raw data is being elaborate into analysis of the data and variables which will include how the research variables can be tested.

CHAPTER IV RESULTS AND ANALYSIS

The fourth chapter of the research will show the analysis done by the researcher which will provide the answer to the problems formulated in the first chapter and also how the data that had been gathered will be analyzed.

CHAPTER V CONCLUSION AND RECOMMENDATION

The fifth chapter of the research will be the overall conclusion from the results of the research, implication of the research, the limitations of this research, and also recommendation given by the writer in regards of the analysis.