CHAPTER I
INTRODUCTION

1.1 Background of The Study

Corporate governance is important for companies because it is the way how the company monitors itself. It is a custom-made method, policy and law set by company for their employees. Board of directors are responsible for the governance of the company and their job is to satisfy the shareholders by using corporate governance.

The idea of corporate governance first arose in 1990s due to series of high-profile corporate scandals and collapses and had been given a boost by the eruption of several major financial scandals in 2001 to 2003 such as Enron, WorldCom, and Parmalat. More fundamentally, corporate governance is a natural by-product of the changing economy. Corporate governance was first introduced to listed companies in the United Kingdom (UK) and United States of America (USA), where firms were generally more widely held, before spreading to countries where the frequent cohabitation of family shareholders and minority shareholders also raises issues of corporate governance (Vernimmen et al., 2014).

In 2001, the rules of corporate governance were in accordance with legal provisions and norms in developed countries. The prevalence of corporate governance causes the implementation of corporate governance as a non-factor that has a significant impact to increase the value of shares of the company. The implementation of corporate governance in a developing country has a big difference with the implementation of corporate governance in a developed country. The big difference is what makes corporate governance as a factor that has significant impact to increase the value of shares of the company (Wibowo, 2010).

The concept of corporate governance started frequent discussion in mid-1997 in Asia, including Indonesia, which at the time was facing an economic crisis. Indonesia started implementing Good Corporate Governance (GCG) after signing the Letter of Intent (LOI) with IMF (Wibowo, 2010). To make the implementation of GCG run smoothly, the government in Indonesia formed an institution named *Komite Nasional Kebijakan Governance* (KNKG) in 1999. KNKG has the responsibility to arrange and develop recommendations for national corporate governance policy, such as a Code for Good Corporate Governance (*Pedoman Tata Kelola Perusahaan yang Baik*). In addition, State-Owned Enterprise (SOE) or *Badan Usaha Milik Negara* (BUMN) has the obligation to implement GCG in order to increase the value of the company. Private sector also gives significant contribution in the development and socialization of GCG. Furthermore, there are some organizations which intended to socialize GCG in Indonesia, such as Forum for Corporate Governance in Indonesia (FCGI), *Ikatan Komite Audit Indonesia* (IKAI), and Indonesia Institute for Corporate Governance (IICG) (Djauhari and Sihotang, 2010).

As one of the organizations in Indonesia that has a role in internalization of GCG, IICG has consistently conducted an assessment of the implementation of GCG by public companies in Indonesia. IICG created a program called Corporate Governance Perception Index (CGPI) with the main objective to serve as an analytical tool to improve the application of the principles of GCG. CGPI also serve to provide information to investors and creditors in assessing the corporate governance practices of public companies in Indonesia (Adam et al., 2015).

Implementing GCG means that we have to know and adopt the GCG principles. The adoption of GCG principles, which are Transparency, Accountability, Responsibility, Independency, and

Fairness (TARIF), has been widely acknowledged as the best standard of corporate governance practices. Indonesian companies had implemented the principles since 2001. At first, most companies in Indonesia experienced difficulties in implementing GCG, due to lack of references or models for the implementation and the resistance to change attitude among business executives. Even after more than ten years of experience, many companies still struggle to find the best model on the implementation of GCG. Many of them employ technical assistance from private or government institutions, but some of them decide to design it by themselves (Wibowo and Gunawan, 2015).

Theoretically, the implementation of GCG can increase the value of the company, because it can reduce risk that may be made by the board with the decision that benefit themselves and generally corporate governance can increase the level of investor confidence. The increased level of confidence was because of the well implementation of GCG that provided effective protection to the investor in obtaining a reasonable return of investment (Abriyani, Wiryono, and Sumirat, 2012).

On the other side, if the implementation is weak, it can cause problems for a company, such as low investment return. A weak corporate governance is one of the causes of the monetary crisis in Asia. The main weakness of corporate governance is the act of selfishness done by the company's managers. If managers carried out task that are only beneficial for themselves and ignored the interests of investors, it would cause a decrease in investors' return (Nofiani and Nurmayanti, 2010).

A weak corporate governance can lead to low value of the company. So, to avoid that situation, powerful institutional investors can encourage GCG because their influence on management is considerable and thus, will tend to act as a mechanism for aligning the interest of managements with those of shareholders, or at least of some shareholders (Simpson and Taylor, 2013). The implementation of GCG in a company's financial performance is the key of success to gain long-term profits and to compete well with global business (Windah and Andono, 2013).

Also, a company that implement GCG will be easier to get through the difficulties in today's competitive world. This is because GCG strengthen the financial and all internal aspects, and also makes the company able to account for all the decisions and policies taken for the social community. With the economic situation deteriorating, society often observing the company's performance and they become more thorough and want to know how a company works. This happened because society believe the velocity of money that affected the economy was mostly controlled by companies (Supit, 2016).

Besides assisting a company get through difficulties in competitive world, GCG is also a factor that influence financial performance. Because the principles of GCG basically have a goal to make progress towards the company's financial performance. If the company has a well implemented corporate governance, then a better company's performance is expected (Wati, 2012).

There are many ways to measure financial performance, but all measures should be taken in aggregate. An optimal performance measures rely on both accounting and market information. Financial performance term is used as a general measure of a company's overall financial health over a given period of time and can be used to compare similar company across the same industry, compare industries, and sectors in aggregation (Soewignyo, 2012). In measuring financial performance, there were some variables that were most commonly used during the year 1996-2010, which were ROA, ROE, sales growth, return on sales (ROS), contribution margin, Tobin's Q, market share, Firm's Risk, return on capital (ROCE), operating income, cash flow, and share earnings (Chiarello et al., 2014).

Indonesia is a highly suitable country to examine the relationship of financial performance to corporate governance, as Indonesia has the effort to improve corporate governance. Also, when the global recession happened, it did not wreak as much havoc in Indonesia. Thus, it made Indonesia as one of the fastest growing economies in the G20 League of Nations (Soewignyo, 2012).

The company's financial performance would be optimal if the company implements GCG. The company is expected to be more optimal in achieving the corporate goals after implementing GCG, because it shows transparency and professional management, which give positive effect for the improvement of financial performance of the company (Budiyanto and Hudiwinarsih, 2015).

There are several studies that will clarify the explanation above, where corporate governance affects the financial performance. A research done by Prasinta (2012) showed that there was no positive relationship between GCG and ROA, there was no relationship between GCG and Tobin's Q, but there was a positive relationship between GCG and ROE. Although a research done by Meythi and Devita (2011) showed that there was no influence between the implementation of GCG and financial performance measured using ROE. Another result of a research done by Nofiani and Nurmayanti (2010) showed that the implementation of GCG had a positive and significant relationship effect on ROE, Net Profit Margin (NPM), and Tobin's Q.

Based on the paragraph above, this research will limit its variables to Corporate Governance Perception Index (CGPI), return on equity, and Tobin's Q. This research will limit its observation more on the company that are listed in the GCG ranking and examine the relationship between good corporate governance and financial performance. The sample used on this research are companies that are listed in the GCG ranking and Indonesia Stock Exchange (IDX) during the period 2012-2015.

According to the explanation above, the title for the research is "**The Impact of Good Corporate Governance on Company's Financial Performance (A Study on Companies Listed in Indonesia Stock Exchange 2012-2015)**".

1.2 PROBLEM LIMITATION

This research will examine the implementation of GCG and financial performance in companies which are listed in IDX and those listed in the ranking of GCG implementation held by IICG. The data will be obtained from financial statements of the companies in both IDX and IDN Financials starting from year 2012-2015, IICG website and SWA magazine. This research will focus on the relationship between GCG and financial performance, where CGPI as the indicators of GCG and Return on Equity (ROE) and Tobin's Q as the indicators of financial performance.

1.3 PROBLEM FORMULATION

Based on the background of this research, the formulation of the research problems are as follows:

1. Does the implementation of Good Corporate Governance significantly affect the company's financial performance measured by ROE?
2. Does the implementation of Good Corporate Governance significantly affect the company's financial performance measured by Tobin's Q?

1.4 Objective of The Research

The research on the impact of GCG on company's financial performance listed on IDX aims as follow:

1. To know how the implementation of GCG significantly affect the company's financial performance measured by ROE.
2. To know how the implementation of GCG significantly affect the company's financial performance measured by Tobin's Q.

1.5 Benefit of The Research

The benefits expected by the writer through this research are divided into theoretical and practical benefits.

1.5.1 Theoretical Benefit

The theoretical benefits of this research are:

1. For academics, to have more information about the research and use it as a source of knowledge related to this research.
2. For future researchers, this research can be used to gain more knowledge and can be used as a reference for them to pursue further research.
3. For the writer, this research can be used to gain more knowledge and deepen her understanding regarding the relationship between good corporate governance and financial performance.

1.5.2 Practical Benefit

The practical benefits of this research are:

1. For other researchers, this research can be used as a reference for further research conducted in the future and can also be used as additional information.

2. For company, this research can help in matter such as preventing corruption, lower unemployment rate, improve company's performance and attract investors to invest in the company.

1.6 Systems of Writing

Chapter I-Introduction

This chapter will describe background of research which consists of agency theory, GCG, principles of good corporate governance, Corporate Governance Perception Index (CGPI), financial performance, and relationship between good corporate governance and financial performance; problem formulation; problem limitation; objective of the research; benefit of the research and systems of writing will be discussed in details.

Chapter II-Literature Review

This chapter is about literature review and hypothesis development. It consists of theoretical background of this research that explains about agency theory, corporate governance, and financial performance. Previous researches that are related to this study are listed in this chapter, hypothesis development, research model and framework of thinking.

Chapter III-Research Methodology

This chapter explains the details of research methodology. Research design in this research uses quantitative method by having descriptive and correlational study, population and sample, data collection method, operational variable definition and variable measurement and data analysis method will be clarified in this chapter. In short, this research is a quantitative research that use secondary data of companies listed in Indonesia Stock Exchange and GCG implementation ranking during the year 2012-2015. This research is using purposive sampling technique and the data analysis method is using simple linear regression model. This research also includes classical assumption test to ensure the quality of the data is unbiased.

Chapter IV-Data Analysis and Discussion

Chapter four is about data analysis and discussion. This chapter focus more on companies that are listed in Indonesia Stock Exchange and GCG ranking, describe the general view of the research object, display the data analysis, and discuss the result obtained from the data analysis.

Chapter V-Conclusion

The last chapter give conclusions from the previous discussion, the implications of the results and recommendations will also be expressed.