CHAPTER I

INTRODUCTION

1.1. Background of the Study

LQ 45 index is a list of the most actively traded equities on the Indonesia Stock Exchange, and it might reflect the 45 most liquid equities. Shares that can be included in the LQ 45 market index are also determined by the company's financial state and future development potential. The firms that are featured on the LQ45 index have the best liquidity and market capitalization ratings in the Indonesia Stock Exchange. Firms in the LQ45 index are generally considered as companies with high performance and because of this, LQ45 index often become investors' reference in making stock investment.

Stakeholders view financial success as one of the metrics for evaluating a company's qualities. For this reason, investors may be more interested in investing in a firm that has a solid financial performance. One of the indicators that often used by investors to measure a company's financial performance is Return on Equity (ROE). ROE is a financial measurement that reveals how much profit a firm earns with the money invested by its owners. According to Hermuningsih (2013, as cited in Andriana & Panggabean, 2017), a company's financial performance improves with a higher ROE.

In today's competitive business environment, all organizations must try to maximize profits from their operations to ensure the company's business continuity. Besides, company must also be able to manage risks effectively. To attain these objectives, good corporate strategy and management are needed. One of the elements of good firm management is regulating the interaction between management, shareholders, the board of commissioners, and other stakeholders, which is known as corporate governance.

Following the monetary crisis that shook Asian economies in the late 1990s, measures to reform corporate governance frameworks at the national and regional levels arose. According to a research done by the Asian Development Bank (ADB), poor corporate governance was a key cause to the economic crisis. As a result, the Asian crisis became a major catalyst for corporate governance reform throughout Asia, including Indonesia. The Asian financial crisis forced the Indonesian government to address the issue of corporate governance in the country. As a result, in 1999, the coordinating minister for Economy, Finance, and Industry established the National Committee for Corporate Governance Policy to suggest national Good Corporate Governance (GCG) standards (Kelvianto & Mustamu, 2018).

Good Corporate Governance (GCG) is essential for a company's success and survival because it is one of the pillars of the market economy system. GCG implementation promotes healthy competition and a favorable business environment. To develop a clean and authoritative government, the government is currently attempting to establish good governance throughout its bureaucracy.

Table 1.1 Market Ranking Good Corporate Governance in Asia 2020

Country	2020
Australia	1
Hong Kong	2
Singapore	3
Taiwan	4
Malaysia	5
Japan	6
India	7
Thailand	8
Korea	9
China	10
Philippines	11
Indonesia	12

Source: Asian Corporate Governance Association (2021)

According to the Asian Corporate Governance Association (ACGA), Indonesia ranked 12th out of 12 Asian countries in the implementation of Good Corporate Governance. Indonesia is obtained low scores in the realization of GCG as ACHA views corporate governance reforms as low on government priorities and direction made is unclear.

GCG is frequently linked with financial performance because it is tied to confidence in both the firms that carry it out and a country's business climate. There are several indicators for good corporate governance mechanisms such as independent board of commissioners, managerial ownership, and institutional ownership. The table below presents how good corporate governance mechanisms are linked to financial performance.

Table 1.2 Good Corporate Governance Indicators and ROE 2017-2018

CODE	YEAR	INDEPENDENT COMMISSIONERS	Increase/ Decrease	INSTITUTIONAL OWNERSHIP	Increase/ Decrease	MANAGERIAL OWNERSHIP	Increase/ Decrease	ROE	Increase/ Decrease
AKRA	2017	0.33	No Increase/ Decrease	0.58	Increase	0.00577	Increase	0.14	Increase
AKRA	2018	0.33		0.59		0.00675		0.16	
BBNI	2017	0.50	Increase	0.93	Decrease	0.00003	Decrease	0.14	Decrease
BBNI	2018	0.56		0.97		0.00002		0.14	

Source : Prepared by the writer (2021)

As presented in table 1.1, the improvement of corporate governance mechanisms within an organization are somehow congruence with the financial performance of the organization. It is reflected on the table where the direction of ROE necessarily follows the direction of the corporate governance mechanisms. Table 1.1 shows that two of the three corporate governance mechanisms of PT AKR Corporindo Tbk (AKRA) are shown to be increased in which is also followed by the increase of the ROE. In addition, the decrease of two of the corporate governance mechanisms of PT Bank Negara Indonesia Tbk (BBNI) are also followed by the decrease of the ROE.

However, evidence from most previous studies suggests otherwise. A study conducted by Fadillah (2017) found that independent board of commissioners, managerial ownership, and institutional ownership have negative effect to financial performance. A similar result was also obtained by Andriana and Panggabean (2017) who claimed that managerial ownership, institutional ownership, and the proportion of independent commissioners do not have significant effect on financial performance. But, a research by Novitasari et al. (2020) found that institutional ownership and managerial ownership have positive effect on financial performance whereas board of commissioners has no effect on financial performance. Contrasting to the result obtained by Novitasari et al. (2020), Nurkholis and Damayanti (2020) discovered that board of commissioners has a significant positive effect on financial performance. Furthermore, Deswara et al. (2021) revealed that institutional ownership has no effect on financial performance.

Gap between the expected outcomes of good corporate governance on financial performance as well as the inconsistent results of previous studies on this topic is what initiated the writer to examine the research with the title, " The Effect of Good Corporate Governance on Financial Performance of LQ45 Index Companies Listed in the Indonesia Stock Exchange.

1.2. Problem Limitation

Due to limited research time and resources, this research has several limitations as follows:

a. Data collected for this study is obtained only from the LQ45 index companies listed in the Indonesia Stock Exchange.
b. The independent variable of this study, namely good corporate governance, is proxied by three indicators: independent commissioners, institutional ownership, and managerial ownership.

c. The dependent variable of this study, namely financial performance, is proxied by return on equity (ROE).

d. Data used in this study are data from the year 2015 to 2019.

1.3. Problem Formulation

To address the issues mentioned in the background of this research, the following research questions are formulated:

a. Do independent commissioners have effect on ROE of LQ45 index companies listed in the Indonesia Stock Exchange?

b. Does institutional ownership have effect on ROE of LQ45 index companies listed in the Indonesia Stock Exchange?

c. Does managerial ownership have effect on ROE of LQ45 index companies listed in the Indonesia Stock Exchange?

d. Do independent commissioners, institutional ownership, and managerial ownership have simultaneous effect on ROE of LQ45 index companies listed in the Indonesia Stock Exchange?

1.4. Objective of the Research

Following research objectives would describe what this research aims to achieve:

a. To discover whether independent commissioners have effect on ROE of LQ45 index companies listed in the Indonesia Stock Exchange.

b. To learn whether institutional ownership has effect on ROE of LQ45 index companies listed in the Indonesia Stock Exchange.

c. To find out whether managerial ownership has effect on ROE of LQ45 index companies listed in the Indonesia Stock Exchange.

d. To determine whether independent commissioners, institutional ownership, and managerial ownership have simultaneous effect on ROE of LQ45 index companies listed in the Indonesia Stock Exchange.

1.5. Benefit of the Research

The results of this research are expected to benefit readers both theoretically and practically. Followings are some of the most important benefits of this research.

1.5.1. Theoretical Benefit

Theoretically, this research is expected to provide valuable information and extend the existing knowledge regarding Good Corporate Governance and how financial performance relates to the practice. This research can also be used as a reference for future researchers who are interested in performing a research of a similar topic.

1.5.2. Practical Benefit

Some of the practical benefits expected from this research are:

a. Investors and Creditors

The outcome of this study is expected to aid investors and creditors in assessing and analyzing the performance of publicly listed companies, specifically the LQ45 index companies, as well as in making investment decisions.

b. Companies and Practitioners

In this research, evidence of how good corporate governance can affect financial performance is provided and therefore the results of this research could serve as considerable information for companies and practitioners in setting up the organizational structure and ownership proportion that most benefit them.

c. Indonesian Government

This research is expected to serve as a valuable consideration for Indonesian government in making rules and regulations related to Good Corporate Governance.