CHAPTER I
INTRODUCTION

1.1 Background of Study

Corporate governance is described as the processes, mechanisms, and relations through which the interests of a corporation's stakeholders are balanced. With such description, it is not only found in companies, but also various organizational forms (Anheier & Abels, 2020). The fall of giant corporations like Enron and WorldCom has proven how essential corporate governance is to ensure effective internal control, maintain organizational integrity, and protect stakeholders' interests (Menexiadis, 2021). Therefore, it is not surprising that the topic of corporate governance has significantly attracted researchers and practitioners' attention in recent years (Mahmood et al., 2023).

A study done by (Al-ahdal et al., 2020) on firms listed on the India and Gulf Corporation Council (GCC) countries revealed that corporate governance practices like board accountability, transparency and disclosure, and audit committee has insignificant impact on firm performance. Another research on Ghanaian listed firms by (Puni & Anlesinya, 2019) found that ownership structure, board size, board composition, and frequency of board meetings have positive impact on firm performance, while CEO duality poses no impact, and board committees has negative impact.

The rise of corporate governance as the hottest issue amongst business executives started centuries ago following the fall and crises of corporate failures.

For Indonesia, these failures are the 1997 – 1998 regional financial crisis and global financial crisis in 2008. Following the 1998 crisis, the government developed general guideline of Good Corporate Governance as an effort to escape from the crisis. It started in 1999 with the establishment of the *Komite Nasional Kebijakan Corporate Governance* (KNKCG). At the same year, the KNKCG would go on to publish the first general guidelines for GCG in Indonesia, which was later revised in 2001 and 2006 (Saptono & Purwanto, 2022).

The regulatory framework adopted by Indonesia for GCG is based on the principles of Organization for Economic Co-operation and Development (OECD). When OECD revised its Principles of Corporate Governance to increase the effectiveness of GCG by adding in elements of the government and society in 2004, Indonesia also adapted to the change by changing the *Komite Nasional Kebijakan Corporate Governance* (KNKCG) to the *Komite Nasional Kebijakan Governansi* (KNKG). KNKG is subdivided into the Public Subcommittee and Corporate Subcommittee (Moegiarso, 2021).

In the 2006 publication of General Guideline of Indonesian Good Corporate Governance by *Komite Nasional Kebijakan Governansi* (KNKG), it was revealed that the lack of GCG application in companies, especially business ethics, have become a major driving force for the 1997 – 1999 financial and monetary crisis, which later spiraled into a long-term multidimensional crisis. Due to this, the General Guideline included a chapter that discusses business ethics and code of conduct.

Business ethics is a reference for a company to use when navigating its business conduct, including its interactions with stakeholders. Its main function is to serve as a guide for the company in realizing its moral values. When applied consistently, ethical business conduct will translate into a company culture that was manifested from these moral values. Both business ethics and moral values will be elaborated further in the form of a code of conduct. A code of conduct consists of guidelines regarding conflict of interests, gifts and donations, rule compliance, secrecy, and protection for whistleblowers.

The five principles of good corporate governance are transparency, accountability, responsibility, independence, and fairness. Each principle must be present to achieve business sustainability by taking stakeholders into account.

The transparency principle must be practiced by providing material, relevant, and easily accessible information to stakeholders in a quick, correct, and objective manner. However, this principle does not hinder companies from upholding the guarantee of confidentiality when involved with the law, official secrecy, and rights of privacy.

The accountability principle must be practiced by establishing a clear description of tasks and responsibilities of departments and employees that align with the company's vision, mission, values, and strategies. Companies must also make sure that all departments and employees have the capabilities to carry out their tasks by setting up an effective internal control to execute the reward and punishment system that drives the company towards its business objectives, all

while acting in accordance with the agreed upon business ethics and code of conduct.

The responsibility principle must be practiced by obeying the law and carrying out corporate social responsibility (CSR) to maintain sustainability and earn recognition as a good corporate citizen.

The independence principle must be practiced by each department in a company. There must be no domination or intervention, conflict of interest, or pressure within the company. Each department must carry out its responsibility and function in accordance with the law without shifting them to each other.

The fairness principle must be practiced by taking the stakeholders' interest into account when conducting business activities. The company must provide equal treatments and opportunities for stakeholders to provide feedback and opinions, as well as equal employment opportunities without discriminating against race, religion, gender, or physical condition (Komite Nasional Kebijakan Governance, 2006).

However, in the 2021 publication of General Guideline of Indonesian Corporate Governance by *Komite Nasional Kebijakan Governansi* (KNKG), the elaboration of business ethics and company values have evolved into a more specific set of rules and instructions for the Board of Commissary and the Board of Director. Some examples include but not limited to avoiding asking for or receiving payment, gratification, or other benefits from third parties for their own self or other people that will result in a conflict of interest, not taking advantage of company's and customer's properties, information, and assets for their own benefits, and

keeping a close eye on all matters regarding money laundering, terrorism financing, bribery, corruption, fraud, political involvement, and lobbying that might be happening in the company (Komite Nasional Kebijakan Governansi, 2021).

Such drastic difference between the 2006 and 2021 publication by the same committee demonstrated the progress that has happened in the corporate governance policy not only in Indonesia, but also all over the world in 15 years' time.

Indonesian companies have exhibited major developments in implementing good corporate governance mechanisms, mostly motivated by regulations issued by the Indonesian Financial Services Authority (*Otoritas Jasa Keuangan*) which were aimed to improve governance standards among listed companies. Since Indonesian companies gradually have more independent board structures due to Indonesia Financial Services Authority regulations that requires at least 30% of Board of Commissioners to be independent directors, improvement in transparency amongst Indonesian companies due to stricter disclosure requirements and existence of audit committees are becoming a norm (Rachmadi & Saktiawan, 2024).

However, these developments are not without issues. Family-owned businesses can cause a lot of conflicts of interest, hinder independence, and shy away from transparency in their governance, going as far as to disclosing information for the sole purpose of sending positive, but untrue signals to the market. This can be seen by the number of family-owned businesses collapsing suddenly due to information asymmetry and lack of corporate governance. The lack of appointment of high quality auditors and/or audit committees is also prominent in family-owned

businesses, which is a contributing factor to the lack of transparency often associated with such businesses (Arora, 2023).

Table 1.1 Phenomenon

No	Company Code	Year	GCG	FP
1	CLEO	2018	0	0.08464
		2019	0.00025	0.125783
		2020	0.0006	0.103887
		2021	0.00374	0.135918
		2022	0.00203	0.124561
		2023	0.00742	0.158565
2	SMGR	2018	0.15729	0.061673
		2019	0.15746	0.036636
		2020	0.14553	0.035388
		2021	0.14464	0.02562
		2022	0.1341	0.028712
		2023	0.12915	0.026344
3	ARNA	2018	0.19874	0.096258
		2019	0.19824	0.124874
		2020	0.1875	0.171383
		2021	0.18578	0.223502
		2022	0.17544	0.238974
		2023	0.16902	0.171287

Source: Prepared by Writer (2024)

The first company shown on the table, PT. Sariguna Primatirta Tbk. (CLEO), which is a non-cyclical manufacturing company, demonstrates a consistent fluctuation between its good corporate governance proxied by institutional ownership and its firm performance. Firm performance increases when institutional ownership increases and vice versa, except for the year 2020 where firm performance weakened despite the increase of institutional ownership, which may be explained by the COVID-19 pandemic that started that year.

The second company is PT. Semen Indonesia (Persero) Tbk. (SMGR), a basic materials manufacturing company. It shows a consistent fluctuation between its

institutional ownership and firm performance, too, with firm performance steadily climbing down just like institutional ownership, except for the year 2022 where a slight uptick happened in its firm performance despite the decrease of institutional ownership.

However, PT. Arwana Citramulia Tbk. (ARNA), an industrial manufacturing company, experienced the opposite phenomenon. Despite its steady decrease of institutional ownership, its firm performance kept increasing except for the year 2023, where a decrease happened instead.

Ownership structure is one of the most significant factors in good corporate governance, since it dictates how balanced the power existing in a company is. The most basic understanding of ownership in companies usually involves a board of shareholders as the owner of the company and a board of directors and commissioners as the managers of the company. Institutional ownership involves the existence of financial institutions like investment banks, insurance companies, and mutual funds companies as shareholders of companies (Hidayat et al., 2020).

It is generally believed that institutional ownership will increase the efficiency of companies' asset management and deter management waste, since institutional investors can act as a monitoring party for the companies (Putra et al., 2022). However, as shown by the table discussed prior to this, there is no definite proof that can be used to assume that this statement stands true. While some companies experience an increase of firm performance when its institutional ownership increases, few others cannot say the same for themselves.

The companies taken as examples on the table above belong to the manufacturing sector. This sector is also the population of this research's samples, since the manufacturing sector makes up the biggest portion of listed companies in Indonesia, as well as the biggest contributor of GDP, employment, and export revenues. With the size of the sector, it is inevitable that the manufacturing sector is made up of all types of industries, ranging from food and beverages industry to heavy machinery industry. The diversity of its ecosystem allows for a more comprehensive analysis of how good corporate governance impact firm performance in this sector. More research and analysis of the impact of good corporate governance on the manufacturing sector would also boost its competitiveness, especially being the backbone of Indonesia's economy and exporting power in the global stage (Kementerian Perindustrian, 2023).

Firm performance is the capability a company has to generate profit through its resources effectively. The most common measures for it includes Tobin's Q, Return on Assets (ROA), and Return on Equity (ROE) (Taouab & Issor, 2019). Despite its straightforward definition, a company's performance carries crucial impact on stakeholders. For shareholders, strong firm performance leads to increased shareholder wealth (Boaventura et al., 2020), while for management, a strong firm performance is a proof of alignment between management practices and company's goals (Bhutta et al., 2021). Even regulators rely on firm performance data to monitor and maintain stability in the market, foreseeing potential market disruptions and taking preventive measures for it (López et al., 2020).

Amongst the various research done previously on the same topic, ownership structure, board independence, and Corporate Social Responsibility (CSR) are the most common indicators used to measure corporate governance. However, not all of them agreed on the same result. Ownership structure and board independence are mostly discovered to have positive significant effect on firm performance, but there are research that found it to have no influence on firm performance. CSR, on the other hand, is found to have positive and significant impact toward firm performance in some research while found to have negatively significant impact toward firm performance in the others. It is highly likely that these inconsistencies were caused by the different sectors, timeline, and control variables used in these previous studies. Considering how important the manufacturing sector is towards the Indonesian economy, the need for updated research in the academic field, and the collective gradual realization of the importance of good corporate governance, the writer is encouraged to perform own research titled "**The Impact of Good Corporate Governance (GCG) on Firm Performance in Manufacturing Companies Listed on the Indonesia Stock Exchange**".

1.2 Problem Formulation

The problem formulation in this study is:

1. Does good corporate governance have significant impact on firm performance?

1.3 Objective of the Research

This research's objective is to examine the significance of good corporate governance towards firm performance in the manufacturing sector companies listed on the Indonesia Stock Exchange.

1.4 Benefit of the Research

1.4.1 Theoretical Benefit

This research is meant to contribute to the development of scientific knowledge in the fields of financial accounting and corporate governance. Other than that, future researchers may cite this research when doing their own research of similar topic, aiding in the expansion of comprehensive knowledge regarding corporate governance and firm performance.

1.4.2 Practical Benefit

For management, this research is expected to provide understanding about good corporate governance and its relationship with firm performance, especially for manufacturing companies, which will aid management in deciding the direction of the company's growth. For stakeholders, this research is expected to provide insights about corporate governance and its implications toward firm performance, which will influence them to make better decisions on which companies to be involved with. For regulators, this research is expected to provide insights for authorities and regulators, aiding in the development of better, more robust, and applicable regulations regarding corporate governance.

1.5 Problem Limitation

This paper does not bring all elements that could influence firm performance into account. Thus, this study has one independent variable, four control variables, and one dependent variable. The independent variable is good corporate governance, while the control variables are efficiency, leverage, firm age, and liquidity. This study also limits the manufacturing companies to the ones registered on the Indonesia Stock Exchange within the period of 2018-2023.