CHAPTER 1

INTRODUCTION

1.1 Background

The monetary crisis which occurred in Indonesia since 1997 has grown into a multi dimensional crisis including the economy causing many large corporations are forced to out of business. One of the factors that cause of action is a result of the weak implementation of good corporate governance. Weak implementation of corporate governance system is one of the factors determining the severity of the crisis that occurred in South-East Asia (The World Bank, 1998; Oktapiyani, 2009; Sari, 2010). Such weaknesses include the lack of openness of the company in the form of reporting financial performance and management of the company especially for companies who have yet to go public. Furthermore, the lack of commissioners' empowerment as an organ of the supervision to the activity of management, as well as the inability of accountants and auditors as a contributor over the company's financial supervision system also is the cause of the issue. Weak implementation of good corporate governance can cause the company could not achieve its objectives. Those objectives namely the maximum profit, to excel in business competition, and fulfill the various interests of stakeholders.

Chinn (2000) and Shaw (2003), as cited in Kaihatu (2006), stated the two main theories related to corporate governance are *stewardship theory* and *agency theory*. Stewardship theory is a theory which assumes that humans are trustworthy, have integrity, honesty, and responsibility. This theory explains that in fact every human can be trusted in act, where the relationship with the implementation of good

corporate governance is to act good to the stakeholders. The second theory is the agency cost, where the theory is caused due to the conflict of interest of the various parties that could hamper the implementation of good corporate governance.

Along with the times, it needs good corporate governance through strong management commitment, and healthy business culture to create a competitive advantage. It can support the company to create a high competitiveness both domestic and foreign. Good corporate governance is an important issue that is now becomes the company's attention. The application of corporate governance is not the responsibility of a part in the company but rather an awareness of participating and cooperation within the entire organs of the company. Through the implementation of corporate governance, conflict of interest is expected to be reduced so as to achieve optimum benefit for all stakeholders of the company. According to Kaihatu (2006), the application of corporate governance has a principal of *transparency*, *accountability*, *responsibility*, *independency*, and *fairness*.

Through the implementation of good corporate governance, are expected to form a good and strong investor perception against company in Indonesia related to the provision of capital to run the economic activity. Based on the research, investor perceptions of firm value is very important in making investment decisions. Good corporate governance (GCG) is an added value for the company, where more than 70% of institutional investors are willing to pay more shares of the company that "well governed" (McKinsey & Co, 2002).

The rising demands for corporate governance application make the investor's position to urge improvements in governance practices which will be the provision, as a guide for companies to conduct their governance and disclosure practice's

improvement. As stated by Melis (2004), it involves a good level of disclosure and decent information in a good system of corporate governance, to decrease information asymmetries between all parties and given the impact of responsible attitude for the act committed people in the company.

In Malaysia, there is empirical evidence about the relationship between corporate governance and corporate disclosure. Mohamad and Sulong (2010) is the most recent reference that addresses the relationship between corporate governance mechanisms and extent of disclosure in Malaysia context. They demonstrate that "*The evidence supports the conjecture that companies with higher percentage of family members sit on the board are significantly have lower level of disclosure in their annual report.*" (Mohamad & Sulong, 2010)

In their study, the four largest industry sectors of listed company in the Main and Second Board of Bursa Malaysia are focused to fulfill the research. Those four sectors are consumer, industrial, construction, and trading or service sectors (Mohamad & Sulong, 2010). Whereas, this study will extent the sample, not only concern on the four largest industry sectors in Indonesia but also other industries that engage in Kompas100 index on Indonesian Stock Exchange (IDX).

The purpose of this study is to examine the relationship between corporate governance mechanisms and level of disclosure for listed companies in Indonesia. This study attempts to find out whether the established corporate governance factor which are the proportion of independent non-executive directors, the proportion of independent members of audit committee, and the percentage of family members on the board have significant relationships with level of disclosure, particularly in one of emerging market such as Indonesia.

1.2 Scope

The scope of this paper is about the relationship between corporate governance and level of disclosure in Indonesia. The author takes samples from the reported annual report from year 2008-2010. The data is gathered from companies that listed in index Kompas100 issued on 31 January 2008 by Indonesia Stock Exchange (IDX).

1.3 Aims and Benefits

1.3.1 Aims

The aim of this paper is to contribute to the literature on corporate governance by examining its relationship to the level of disclosure of Indonesia listed firms.

1.3.2 Benefits

This research is expected to provide benefits to several parties, such as:

1. Related companies

   Since the author will collect the sources of information from companies listed in Kompas100, this research is expected to give benefits for those companies towards the relationship of corporate governance and level of disclosure. Through this research, it also can be seen if there is a significant relationship between the mechanisms of corporate governance with level of disclosure.

2. Shareholders

This research also expected to provide benefits for shareholders or investors, who invest in listed companies, in terms of receiving further information affecting their investment decisions.

3. Researchers

This paper is expected to give additional empirical references for another researcher who wants to conduct a study in the same topic area.

1.4 Research Questions

RQ1: Is there a significant relationship between corporate governance mechanisms with level of disclosure in Indonesia listed companies?

RQ2: Is the effect of corporate governance mechanisms on corporate governance disclosure different between large and small companies?

1.5 Hypothesis

H1: The proportion of independent NEDs has a positive relationship with the level of disclosures.

H2: The proportion of independent NEDs in the audit committee has a positive relationship with the level of disclosures.

H3: The percentage of family members has a negative relationship with the level of disclosures.

H4:   The effect of corporate governance mechanisms on corporate governance disclosure is different between large and small companies.

1.6 Research Methodology

This research is an empirical study, using samples from Indonesian public companies that listed in 'Kompas100'. Regression analysis would be use to analyzed the quantitative data gathered from the company's annual report. Moreover, this study is cross-sectional which is conducted in Jakarta, Indonesia. And also the author did some reviews for supporting this paper from related journal articles and textbooks.

1.7 Thesis Structure

This paper consists of five chapters, which are:

CHAPTER 1: INTRODUCTION

In the first chapter, the author will give explanation about the background of the research topics. Afterwards, the author also explains the scope of the research, the aim and benefits of this study. Furthermore, the research question that develops the hypothesis that

will be tested, and also research methodology as the guidance in the research process are also included in this chapter.

CHAPTER 2: THEORITICAL FOUNDATION

In this chapter, the author will provide the theoretical foundation that supports this research. The literature relate with the topic will be explained and elaborated further.

CHAPTER 3: RESEARCH METHODOLOGY

In the third chapter, the author will state deeper about the method of this research to process the data in order to get the answer of the hypothesis.

CHAPTER 4: FINDINGS AND DISCUSSION

Results and findings of the research, which consist of data analysis, empirical results, and the discussion itself, will be explained in this chapter.

CHAPTER 5: CONCLUSION AND RECOMMENDATION

This chapter will provide explanation about the general conclusion of the research by looking at the result and limitation of the study. The author will also give some suggestions for further research.