# Chapter 2
# Literature Review

## 2.1. Corporate Governance Definition

Corporate governance is defined as the system by which corporations are directed and controlled. The definition of corporate governance identifies the distribution of rights and responsibilities among the different contributors in the organization such as the board, managers, shareholders and other stakeholders. The structures of corporate governance state some rules and procedures for decision-making, and the company's objectives are also set in corporate governance structure as well. A 'good' corporate governance system ensures that the corporation sets appropriate objectives and puts systems and structures in place to ensure that these objectives are met, it is considered as a tool for all shareholders to control and monitor the activities of the corporation (Khan, 2011).

As a concept, Good Corporate Governance does not have a single definition. The Cadbury Committee (1992), issued its own definition of Good Corporate Governance. According to the Cadbury Committee, Good Corporate Governance is a principle that directs and controls the company to achieve a balance between the strength and authority of the company in providing accountability to its particular shareholders and stakeholders in general. Some countries define Good Corporate Governance in a slightly similar definition even though there is an insignificant difference in terminologies.

OECD describes Good Corporate Governance as the ways in which corporate management is accountable to its shareholders. This definition has the similar objective to what the Cadbury Committee defines. OECD (2004), defines that corporate governance is a part of the larger economic context in which firms operate, that includes macroeconomic policies and the degree of competition in product and factor markets. The corporate governance framework also depends on the legal, regulatory, and institutional environment. In addition, factors such as business ethics and corporate awareness of the environmental interests of the communities can also have an impact on its reputation and its long-term success. In terms of decision-making process, decision makers in companies must be able to be responsible for their decisions, and the decision itself should be able to provide the added value to other stakeholders. Therefore, the main focus of OECD in relation to the decision-

making process of the company should contain the principles of Good Corporate Governance, such as transparency, responsibility, accountability and fairness.

The definition by Forum for Corporate Governance in Indonesia (FCGI) regarding Corporate Governance is similar with the others that have been mentioned before. FCGI (2001) defines Good Corporate Governance as a set of rules that regulate the relationship between shareholders, managers of companies, creditors, governments, employees and other internal and external stakeholders related to their rights and obligations, or in other words, it is a system that regulates and controlling the company. Another definition of Good Corporate Governance comes from the Finance Committee on Malaysia Corporate Governance. According to the institution, Good Corporate Governance is defined as a process and structure that is used to direct and manage the business of the company towards the increasing business growth and corporate accountability. Whereas, The Indonesian Institute for Corporate Governance (IICG) (2009) defines Corporate Governance as a process and structure that is set in order to operate a company with the main goal to increase shareholders value in the long term while still considering the interests of other stakeholders in accordance with laws and regulations and applicable norms.

Furthermore, according to Wardani, Komite Nasional Kebijakan Governance (KNKG) (2008:7), Good Corporate Governance is one of the pillars of the market economy system. Corporate Governance is closely related to credibility and trust in both company that implement it and in the country's business climate. The application of Good Corporate Governance encourages the creation of healthy competition and a conducive business climate. The adoption of Good Corporate Governance for companies in Indonesia is very important to support the stability and sustainable economic growth. While, Good Corporate Governance according to the Regulation of the Minister of BUMN Number: PER-01 / MBU / 2011 which concerning about the Implementation of Good Corporate Governance (GCG) in Government or State-Owned Enterprises (BUMN), are the principles underlying a process and management mechanism of the company according to the laws and business ethics.

Moeljono (2005), defines Corporate Governance as the system that regulates and controls companies to create added value for all stakeholders. There are two things that are emphasized in this concept, namely the importance of shareholders'

rights to obtain correct (accurate) and timely information, and the company's obligation to make disclosures accurately, timely and transparently to company information, ownership and stakeholders.

From the all definitions above, it can be stated that the approach to the definition of Good Corporate Governance is emphasized more on the approaches of hard factors that require framework as well as policies or regulations that support the implementation of Good Corporate Governance. However, there is also a different perspective by the Corporate Governance Team in Badan Pengawasan Keuangan dan Pembangunan (BPKP) (n.d) regarding the corporate governance definition, they define Good Corporate Governance with a slightly different perspective by including the soft factors in explaining the definition. According to them, Good Corporate Governance is defined as commitment and business practices in healthy and ethical approach by emphasizing the need for commitment in its implementation. They claimed that the existence of policies and the completeness of the Good Corporate Governance framework is losing meaning without a commitment as the fundamental element to implement it. By this sense, how the role of Shareholders, Boards and Top Management as Top Leader have a significant impact in driving the importance of Good Corporate Governance in company with principles, which leads and affects the lower level to emphasize the commitment of Good Corporate Governance implementation.

## 2.2. Theories Explaining Corporate Governance

There has been a study try to explain theories explaining the Corporate Governance. Abdullah & Valentine (2009), finds that there are several theories that can explain corporate governance practice. The fundamental theories in corporate governance began with the Agency theory, expanded into Stewardship theory and Stakeholder theory and evolved to Resource Dependency theory, Transaction Cost theory, Political theory and Ethics related theories such as Business Ethics theory, Virtue Ethics theory, Feminists Ethics theory, Discourse theory and Postmodernism Ethics theory. Li (2012), also finds that CG implementation is affected by culture as there are special issues in China and India regarding whether existing theories of corporate governance are applicable in these two countries, this leads to a statement that there is no general CG implementation that can be applied purely to explain CG

in Asia, as it needs some adjustments due to the culture differences.

According to Abdullah & Valentine (2009), there are several theories explaining corporate governance. However, this research will only emphasize three theories that could perfectly address the issues underlying corporate governance and corporate performance; the theories are the Agency Theory, the Stewardship Theory, and the Stakeholders Theory.

1. Agency Theory

Agency theory is defined as "*the relationship between the principals which is shareholders and the agents which is the company executives and managers*". The development of corporate governance that departed from Agency Theory was developed by Jensen and Meckling in 1976. The theory was based on conflicts and problems arising between the principal and agent. The principal is the party who gives the authorization to the agent to act on behalf of the principal, while the agent is the party who is given the authorization by the principal to run the company. The agents are obliged to account for what has been mandated by the principal to them, however, management as an agent is often considered to act for its own interests, or not as a wise and fair party to the shareholders (principals). The separation of ownership and differences in interests between principals and agents creates agency problems or conflicts of interest. As the party that manages the company, the agent has more information about the company's capacity, company's performance, work environment and the company as a whole. On the other hand, principals do not have enough information about the agent's performance. This results in inequality of information between principals and agents called asymmetric information. This can lead to two problems (Jensen and Meckling, 1976):

a. Moral Hazard: it is a problem that occurs if the agent does not carry out what has been agreed in the work contract.
b. Adverse selection: it is a problem that occurs if the principal does not know whether the decision taken by the agent is based on information that has been obtained or agents are being negligence in their task.

In agency theory, shareholders expect the agents to act and make decisions in the principal's best interest. Conversely, the agent may not necessarily make decisions in the best interests of the principals (Padilla, 2000).

Agency theory is believed as a theory that can explain corporate governance, in the issue of asymmetric information or inequality information between principals and agents, good corporate governance plays a crucial role to reduce agency problem. The existence of corporate governance leads a company to set the framework in order to ensure that their activity is in accordance with the governance, which can minimize principal's misperceptions regarding company's information as it has been set in the legal framework.

2. Stewardship Theory

Unlike Agency Theory, Stewardship Theory assumes that manager is the one who manages with behaviors that are aligned with their principal goals. This theory is based on good tolerance by a manager. In this theory, managers are seen and considered as loyal to the company and interested in achieving high performance. The dominant motive, which directs managers to complete their work, is their desire to do their job very well. In particular, managers are seen as those who are motivated by the need to achieve intrinsic satisfaction through success in carrying out challenging work, as well as to carry out their responsibility and authority to gain recognition from their leaders and other parties for their success. Therefore, there is a 'motivator element' that is non-financial for the manager. This theory also argues that an organization needs a structure that allows harmonization to be achieved from an effective relationship between manager and owner. In other words, Stewardship Theory views management as a party that can be trusted to act for the best interests of the public and stakeholders. Donaldson & Davis (1991), stated that stewardship theory emphasized more on the role of top management, not on the perspective of individualism. The role of top management being as stewards with the integrated objectives as part of the organization, is the underlined concern of stewardship theory as the stewardship perspective suggests that stewards are satisfied and motivated when organizational success is achieved.

Moreover, Daly et al. (2003), claimed that in order to protect the executives and directors' reputation as decision makers in organizations, they are disposed to operate the firm themselves to maximize financial performance as well as to increase shareholders' profits. By this sense, it is believed that the firm's performance can directly impact the perceptions of their individual performance. It is proven as Farma (1980), argued that executives and directors are also managing their careers so that

they can be seen as effective stewards. Additionally, the research suggests to merge the role of the CEO and the chairman in order to reduce agency costs and to have greater role as stewards in the organization, the result shows that there would be better safeguarding of the interest of the shareholders.

Overall, stewardship theory is also believed as one of the theories that can explain corporate governance as a steward is defined as someone who protects the needs of others, which means a steward will protect the interest of the owners or shareholders and will make decision on their best interest. This fact leads to a statement that both objectives of corporate governance and stewardship theory are considered to be aligned. However, it was empirically found that the outcomes have improved by having both agency theory and stewardship theory combined rather than separated (Donaldson & Davis, 1991).

3. Stakeholders Theory

Stakeholder theory can be described as "*any group or individual who can affect or is affected by the achievement of the organization's objectives*". Unlike agency theory, stakeholder theorists suggest that managers in organizations have a network of relationships to serve, not only shareholders, but also the suppliers, employees and business partners. Stakeholder theory states that the purpose of a business is to create value for all stakeholders, not just shareholders. Business needs to consider customers, suppliers, employees, communities and shareholders. It is defined as a view of capitalism that stresses the interconnected relationships between a business and everyone who have a stake in the company. It holds that a company's stakeholders include everyone affected by the company and its workings, that view is in opposition to the shareholder theory that in capitalism, the only stakeholders a company should care about are its shareholders, where companies are obliged to make a profit to satisfy their shareholders, and to continue positive growth.

(Gibson 2000: 247) describes in his journal in the same way that business also has different tasks for various stakeholder groups. In cases where there is a conflict of interest between the shareholders and other stakeholders, the interests of the shareholders must be moderated or sacrificed to fulfill the basic obligations of the other stakeholders. In company law, shareholder is given superior status as the owner of the company. They are able to choose all or most of the Board of Directors

members, they have the rights to hire and fire senior executives as well as approve or reject important policies and corporate strategies. Due to the extraordinary status and the control possessed by the shareholders are stated in company law, stakeholder theory tends to devote less attention to defend the rights of shareholders. The assumption is that the shareholders already have the power to ensure that their interests are taken into account by the company and its managers. Therefore, stakeholder theory that has considered the rights of the shareholders usually tries to show the reason why these rights must be limited and moderated. By the explanation about stakeholder theory, it is believed that the theory can also explaining corporate governance as it also explains how the company should be controlled in order to create value to everyone who have a stake in the company.

From the three concepts that underlie above, it can be seen that the similarity lies in observing the pattern of relationships or interactions between shareholders and management in fulfilling the interests of each party. The effectiveness of these interactions creates a synergy in relationships that positively influences the growth in corporate value. However, Abdullah & Valentine (2009), suggested that a combination of various theories is best to describe an effective GCG practice rather than theorizing corporate governance based on a single theory.

In regards with corporate governance in Asia, according to Li & Nair (2009), corporate governance has turned into an important concern for Chinese and Indian firms as they progressively interact with regulators and investors from developed markets as well as to respond to corporate scandals that have been occurred recently, therefore the urge to encourage good corporate governance implementation is necessary for both emerging countries. There are several researches that has been done regarding the existing theories explaining corporate governance. However, there are special issues in China and India regarding whether existing theories related to corporate governance are applicable in these two largest economies countries in Asia. Researchers who have different perspectives against that Asia needs exclusively unique Asian corporate governance theories would contend that by a definition of, "a theory should be generalizable to different observations across countries" (e.g., Cheng, 1994). They might argue that there are differences in how a theory is applied in various settings, yet a theory, such as agency theory or institutional theory should be general and universal. Conversely, some researchers

contend that the cultural differences of Asian demand for completely new theories related to corporate governance (e.g., Hofstede, 1993; Meyer, 2006). It is proven when China opened up the economy, researchers from China claimed that the country is different from the other Western countries, and therefore China needs to create its own theories.

Qian (2002) arranged a framework to evaluate this issue. He claimed that a well-established discipline should have three dimensions, such as perspective, reference, and analytical tools. Therefore, it is not necessary to create country-specific economics, yet the implementation of existing theories could improve uniqueness and country-specific insights. Overall, it is noted that the unique historical and religious backgrounds, paths of development, the patterns of corporate governance and the interrelationships among the key concepts and relationships of these two countries may be considerably different from what have been established in existing theories. By this sense, this recommends that, a new theory building is required. In spite of that, it should also be noted that this issue in these two countries is not isolated as they are part of a larger global transformation, which means that a large number of corporate governance issues in China and India can also exist in other developing countries, especially in Asia, thus the future theory building should be able to discover patterns that are important and generalizable to developing economies. However, this article leads to a statement that there is no general Corporate Governance implementation to be successful as it needs some adjustments due to the culture differences.

Bauer et al (2008) conducted research in Japan with six provisions governance provided by the International Governance Metrics (GMI), the result shows that those related to financial disclosure, internal control, shareholder rights, and remuneration have a significant influence towards stock price performance. Provisions related to the board accountability, market for control, and corporate behavior are not affecting stock price performance. This provides evidence that not all categories of Corporate Governance are a problem for shareholders in Japan. Moreover, research by Bebhuck et al (2004) also argues that not all Corporate Governance features are a problem for all company. They claim that only several practices that related to shareholder rights and takeover defenses can affect company performance in the United States. Thus, it can be concluded that cultural differences

can also affect outcomes in the state related.

In regards to the culture, Moeljono (2005: 10) states that corporate culture is the core of four contexts, namely GCG, Management, Corporate Social Responsibilities, and Business Ethics. It is stated so because top companies usually have the four characteristics of these advantages. First, the management has a crucial role so that it can create high performance and optimal operating profit. Second, management is maintained by the practice of GCG which consists of five main aspects, namely transparency, independence, accountability, responsibility and justice. Good Corporate Governance is a prerequisite of the quality of corporate management implied in global competition. It is believed that corporations that implement GCG will obtain higher acceptance. Corporations that maintain social responsibility will also get a positive institutional image. This practice is followed by company value which assumed that social responsibility is not a task, but it is "part of corporate life". Finally, a business that prioritized ethics is a business that has a high acceptance, not only in the business itself, but also in the social and political environment.

According to Moeljono (2005: 74-75), corporate culture is the inner side of corporate management, it is become an upstream part of GCG that focus on the basic value of the management which later determined through a system. Corporate Governance concerns on the physical form of company and the behavior of a company, this form can be developed through increasing ability (skill) and increasing knowledge. Meanwhile, corporate culture concerns on the form of attitude. This form of attitude is the personality of the individuals in the company so that it is a collection of attitudes and personality interactions between individuals in the company that will bring character in the company itself, so that it can be said that corporate culture is the core of Good Corporate Governance (GCG).

### 2.3. Benefits of Corporate Governance

Companies that can implement good corporate governance practices are considered to have competitive advantages. With the increasing globalization of business and competition for capital, companies that can provide assurances that they are being appropriately managed can gain a competitive edge. Reducing perceived

risks to investors can reduce the cost of capital. The presence of an effective corporate governance system, within an individual company and across the economy as a whole, helps to provide a degree of confidence that is necessary for the proper functioning of a market economy. As a result, the cost of capital is lower and firms are encouraged to use resources more efficiently, therefore it can support the growth of the company. Particularly, the benefits obtained in implementing good corporate governance are varied, such as improving organizational performance through the creation of better decision-making processes, improving the operational efficiency of the organization, improving services to stakeholders, simplify to obtain cheaper and non-rigid financing funds (due to trust issues) which will ultimately increase the value of the organization (corporate value), and lastly to increase investors' trust and confidence to lend their money. By implementing good corporate governance, it is believed that it will lead to the good performance of the company, as it can be seen in the growth of the size of the company itself, whether it is reflected from its higher investment level or the increasing in sales. (Mallin, 2004)

Berle and Means (1932), find that corporate governance has focused upon the agency problem, in which is the principal-agent problems arising from the distributed ownership in the modern corporation, they found corporate governance as a mechanism where a board of director is an essential monitoring device to minimize as well as to decrease the problems brought by the principal-agent relationship. The separation of ownership from management can lead to a likelihood of managers taking action that may not maximize shareholders' wealth, but could benefit them, not the owners. Hence a monitoring mechanism is required to protect shareholder interests (Jensen & Meckling 1976). By this sense, it can be suggested that corporate governance has a positive impact in terms of reducing agency problem as well as gives benefits to increase financial performance since it can provide assurances to investors which leads to increasing in investment.

It has been argued that corporate governance has a significant impact in the performance of the company as it is an important factor in maintaining stakeholders' trust and confidence. In terms of the investor's confidence, Alnaser, Shaban, & Zubi (2014), find that the investors' confidence emerges because of its effective corporate governance practices. This confidence is ascribed to conclusion that corporate governance is somehow effective because it is complying with state and federal statutes. Also, confidence is recognized from the other assumption that corporate

governance is effective because it is complying with listing standards. And the other assumption is that corporate governance is effective because it implements best practices suggested by investor's activists and professional organizations. The result recommends that in order to maintain the current level of investors' confidence, company should keep its current governance practices under continuous evaluation and assessment process, through developing the legal framework for corporate governance in respect of the proposed development of a conceptual framework, also through appropriate recommendations in order to improve the working processes, and finally by encouraging accounting, economic and legal research, to lead to the best practices to meet the corporate governance requirements.

Based on the research by Malelak & Basana (2015), they hypothesized that Corporate Governance Characteristics that represented by both board structure and ownership structure has a significant impact on firm performance. The board structure includes board of commissioner, board of director and independent commissioner, while the ownership structure includes institutional ownership, managerial ownership and public ownership. However, there are several perspectives associated with this topic. According to Heenetigala & Armstrong (2011), they find that there is positive relationship between corporate governance practices with the firm performance, the governance practices are including separate leadership, board composition, board committee, while the firm performance are measured by return on equity and return on asset. However, Zangina et al., (2009), finds that board size, leverage and income volatility are the significant determinants in terms of the firm value, while inside ownership has no significant effect on firm value especially in terms of share price. According to Klen (2002), Cornet (2008), and Christi & Nugroho (2013), the studies concluded that the high composition of the independent commissioners is seen as a more effective tool in monitoring company performance as the high percentage of independent commissioners can also help to evaluate policies taken by the company. And according to panel data regression analysis, with Return on Equity as a measurement of firm performance, Malelak & Basana (2015) find that there are four variables of corporate governance characteristics that have significant impact on firm performance, those are board of director, independent commissioner, institutional ownership, and public ownership. Meanwhile the board of commissioner and managerial ownership have no significant effect. Thus, companies should pay more attention to the board of director, independent

commissioner, institutional ownership and public ownership, as well as to consider properly the decision related to those aspects because every decision will give an impact to firm performance. This also needs to be emphasized that corporate governance implementation must be structured properly as it can be seen that the firm with good corporate governance structure, has a higher profitability and share price performances. Nevertheless, gap phenomenon also exists in this case because there was inconsistencies direction of the relationship among the variables, in which some researches claimed positively related corporate governance characteristics to firm performance, while some other researchers expressed negatively related corporate governance characteristics to firm performance.

The other measurement of firm performance specifically in financial performance is also Cost of Debt. The level of cost of debt is crucial to measure the performance of a company. According to Juniarty (2012), she believes that good corporate governance is also considered as a tool to lowering the cost of debt in companies. The implementation of Good Corporate Governance in order to lower the cost of debt can be indicated by applying of Good Corporate Governance's principles, such as transparency, accountability, responsibility, fairness and independency. In this case, the role of Good Corporate Governance's principles to the cost of debt (CoD) have been searched by Chen & Jian (2007), they conclude that transparency in providing information will diminish default risk and finally reduce the Cost of Debt. Besides, it is proven that companies which have good rating of their Good Corporate Governance practice will enjoy lower CoD, by this sense, investors are more willing to lend their money with lower interest to the company that has a good rating of GCG since the company is considered to have lower risk. Although it is indicated that Firm Size has a strong effect to the CoD, yet the good rating of Good Corporate Governance also has a positive influence in the growth of the size of the company.

Other than that, according to Halimatusadiah, Sofianty & Ermaya (2015) good corporate governance is the procedure of firm management in running their goals that result in optimal profitability. The research explains that the emergence of corporate governance in Indonesia is triggered by the financial crisis that occurred in this country. As the government expected an improvement of Indonesia's economy, Good Corporate Governance (GCG) emerged as an option to increase companies'

value in Indonesia. Thus, in order to increase the company’s value, profitability is going to be the main focus. They state that profitability is a measure of a company's success in achieving its objectives in a particular accounting period (Halimatusadiah, Sofianty & Ermaya, 2015). Based on the results of their hypothesis testing, there is 19.8% effect of Good Corporate Governance implementation on corporate profitability which measured by Return on Assets (ROA) of the sampled companies. Although it is not a significant number, the researchers suggest that a company should always improve the quality of GCG implementation since it is one of the factors that can improve the company performance, specifically to increase the investors’ level of confidence. Besides, to maximize the financial performance, a company should implement and develop the principles of GCG regularly.

Overall, according to Sutojo and Aldridge (2005: 5), good corporate governance has five goals, as follows:

1. Protect the rights and interests of shareholders
2. Protect the rights and interests of the member of the stakeholders (non-shareholders)
3. Increase the value of the company and the shareholders
4. Improve the work efficiency and effectiveness of Board of Directors and company management.
5. Improve the quality of the relationship of Board of Directors with company’s senior management.

Whereas according to Daniri (2006: 15-16), the benefits of implementing good corporate governance are as follows:

1. Improving the company performance through supervision or monitoring management performance and the existence of management accountability of other stakeholders, based on the regulatory framework and applicable regulation.
2. Provide a reference framework that creates an effective monitoring, thus creating a checks mechanism and balances in the company.
3. Reducing agency cost, which is a cost that must be borne by the shareholders as a result of delegating the authority to management

## 2.4. Corporate Governance on Financial Performance

Corporate Governance failure is a problem that has an impact on financial performance of companies in many countries. This can be seen from the case occurred in the United States (with the collapse of Enron, Tyco, Andersen, and WorldCom), Switzerland (Swissair), Germany (Kirch Media), Japan (Daiwa Bank, Sumitomo Corporation) and any other national system where the rights of shareholders must be protected and the interests of stakeholders need a representative. Governance failures that occur within the company can have a huge impact on a number of stakeholders (stakeholder interests) such as institutional and retail shareholders, retirees, employees, creditors, banks, clients, suppliers, authorities and the public broad (Banks, 2004).

As corporate governance has a huge impact on financial performance, it is believed that companies should fully implement their governance to generate good financial performance. Financial performance will be better and can continue to excel in competition if there are continuous improvements. For this reason, it is necessary to have rules and control mechanisms that effectively direct the company's operational activities and the ability to monitor parties that have different interests. The mechanism to improve and maximize financial performance can be achieved by implementing good governance in the organization, or also known as Good Corporate Governance. (Laksana, 2015).

Zheka (2006) conducted a study of the relationship between corporate governance and financial performance in companies listed in the Enterprise Performance for Open Joint-Stock Companies (OJSC) in Ukraine. The result of this study indicates that there is a positive relationship between corporate governance and financial performance, not only on financial performance of companies that have developed or are developing, but also in companies that are experiencing a transition period. Igor Todorovic (2013) conducted a research on the correlation between corporate governance and financial performance in companies listed on Banja Stock Exchange Wounds. The result of this study indicates that companies with high corporate governance values will have a higher net profit margin and earnings per share. While companies that have lower corporate governance values will have lower net profit margins and earnings per share. This shows that companies with higher

corporate governance values are more profitable and have better performance. Moreover, Attiya and Robina (2006) conducted a research on the relationship between corporate governance and financial performance on companies listed on the Karachi Stock Market in Pakistan. This study uses variables such as board composition, shareholdings and ownership, disclosure and transparency. The result of this study indicates that board composition, and ownership and shareholdings have a positive relationship with financial performance, while transparency and disclosure have no significant influence on financial performance. This is because the source of the financial statement data used does not reveal the information needed to calculate and determine the value of financial performance.

In Indonesia, most companies have not fully implemented GCG. This matter is due to the General Guidelines of GCG in Indonesia that is voluntary, and there are no legal sanctions if the company does not implement the guidelines (Bapepam, 2010). PT Aneka Tambang (Persero) Tbk won a very trusted predicate six time in a row in the Corporate Governance Pereption Index (CGPI) Award. This happens because of Good Corporate Governance (GCG) in that company applied as an integrated business practices and corporate behavior, especially in implementing organizational learning. In addition, the performance of PT Aneka Tambang (Persero) Tbk still remains good in the middle of uncertain conditions of economy. This can be seen from 2010 to 2013 that PT Aneka Tambang (Persero) Tbk always experiences profits despite the unstable economy conditions.

According to Wardhani (2007), one of the factors that influence the financial performance is the application of Good Corporate Governance (GCG). Because the basic principles of Good Corporate Governance (GCG) has a goal to make progress on financial performance in the company. The better the corporate governance implemented in a company, the better the performance of a company is expected. Besides that, according to Tjager et al (2003) with the implementation of Good Corporate Governance (GCG), the company can improve its financial performance by reducing the risk of failure on decision making by board of commissioner as well as to enhance investors' confidence in increasing investment. Related to the relationship between GCG and financial performance, it is claimed that investors will make greater investments in the companies that have good governance than the companies that have a bad governance predicate. (McKinsey & Co, 2002 in Hilb,

2012).

In relation with corporate governance, ownership structure is also important to be discussed. According to Abdurrahman (2005) ownership structure is the composition of shareholders in a company that is calculated based on the number of shares owned divided by all existing shares. The proportion in this ownership will determine the number of majority and minority shareholder in the company.

Company management that are increasingly in separate ownership is one of the characteristics of the modern economy, this is aligned with agency theory that wants the owner of the company (principal) hands over the company to the management and professional staffs (agents) who have more understanding about running a business. The aim of separated management and ownership is that the owner will get maximum profit at an efficient cost. However, in developing countries like Indonesia, agency problems might have a different dimension because it does not only focus on ownership and management, but also focusing on the takeover of company profits by the largest shareholders. In corporate governance framework, different ownership structures have dominant role in determining the company behavior regarding financial and investment decision making, as it is one of the key parameters in decision making process. Company might be in a difficult situation during the decision-making process when managers and shareholders start prioritizing their own interests and personal goals, which is ultimately jeopardizing the company's profitability, future prospects and company survival. In the current company settings, there are some differences in the structure of corporate governance in which ownership structure is dividing into dispersed ownership systems and concentrated ownership system. (Shah et al, 2012).

Moreover, ownership structure is considered as a factor that can affect Good Corporate Governance (Berthelot, 2010). As company goals are very much determined by the ownership structure, the owner will try to establish an effective ownership structure and make various strategies to achieve company goals. Research by Wulandari (2005) shows that the ownership structure has a positive impact on financial performance. Conversely, Vesy (2012) in his research claimed that ownership structure does not affect financial performance.

## 2.5. Corporate Governance Perception Index (CGPI)

In the scale of Corporate Governance in Indonesia, Wahyudin & Solikhah (2012) states that companies with Good Corporate Governance implementation may generate a system for directing, controlling and supervising the entire resources efficiently and effectively. Good Corporate Governance is supposed to maintain various interests in balance which may provide benefits for the company. In order to assess GCG implementation in companies, The Indonesia Institute for Corporate Governance (IICG) has a program called Corporate Governance Perception index (CGPI) and it has been operating since 2001 until now. CGPI is a research program that assessing and ranking Good Corporate Governance implementation in Indonesian companies through research design that encourages companies to improve the quality of the Corporate Governance (CG) application through continuous improvement by implementing evaluation and benchmarking. CGPI is attended by public listed companies (issuers), SOEs, banks, and other private corporates.

One indicator of Corporate Governance in Indonesian company can be referred from CGPI. In general, new companies or start-up companies are willing to take part and participate in CGPI survey if their financial performances are relatively stable and not experiencing problems that are material in their financial statements. Companies that are listed in CGPI ranking score have been proven to have implemented a good corporate governance which directly increase their value of the market shares.

The institution gives Corporate Governance (CG) award to companies that implement good corporate governance. CG award also have a huge impact for the company, not only to get the good reputation in society, but also to increase and maintain investor's confidence to invest in their company. Specifically, there are several benefits of CGPI, firstly, to arrange company that is not yet in line and has not supported the realization of GCG, secondly, to increase awareness and share commitment from internal companies and stakeholders on the implementation of GCG, thirdly, to specify the mapping strategic problems in GCG practices, and lastly, to act as alternative improvements to quality indicators or quality standards. It is also evident that the awareness about GCG enforcement in Indonesia has improved

as the participants in CGPI Awards always increase in both quantity and quality. However, the research shows that Corporate Governance implementation rating is not directly responded by the Indonesian stock market and has not yet been able to increase the company's growth in the short term, yet practical suggestions of Good Corporate Governance implementations are required by stakeholders, as it may give a long-term positive impact. the CG rating in Indonesia was assessed using four stages of process, such as self-assessment, document evaluation, paper assessment and company visit or observations, which was conducted by an independent team. And it also uses the CG index as a measurement, such as compliance, conformance and performance, associated with a variety of accounting-based and market-based performance variables, such as financial performance, market value and growth. From the findings, it discovers that investors and creditors may consider the CGPI rating for their investment decisions. And finally, CGPI rating has a positive impact on financial performance. Thus, the government should stipulate regulations and create conducive situations for GCG enforcement through a regulatory approach on GCG to encourage public companies to participate in the CGPI ranking programs, considering that it is a voluntary program, this strategy is also aim to improve companies' commitments on GCG implementation. It also expected that companies can implement GCG not only to comply with regulations but also to increase their performance and make GCG implementation as part of the corporate culture (Wahyudin & Solikhah, 2012). However, previous research conducted by Cahyaningtyas & Hadiprajitno (2015), and Prasinta (2012), show that the implementation of good corporate governance has an effect on operational performance, however, GCG implementation still not yet affect an increase on financial performance and market response.

As mentioned before, there are several assessment processes conducted by CGPI to evaluate the quality of corporate governance practice in a company. CGPI has 4 stages of assessment which include self-assessment, document assessment, paper assessment and observation. (IICG, 2014)

Self-Assessment is an independent assessment by all elements, members and stakeholders of the company regarding the quality of GCG implementation in the company. At this stage, the company answers a questionnaire by inviting respondents to give their honest and objective perceptions to provide feedback and

evaluation to the company. The list of respondents consists of two respondents, namely internal respondents and external respondents. Internal respondents consist of management (President Commissioner, President Director), Syariah Supervisory Board, Committee members under the Board of Commissioners and executive committees, managerial employees and non-managerial employees including the Corporate Secretary, Internal Audit and Representatives of the Workers' Union. While external respondents consist of institutional investors, minority investors, financial institutions, insurance, industry associations, regulators, partners, rating agencies and many other agencies.

The second stage of assessment is the Document Assessment, the complete document is the fulfillment of the requirements by submitting company's various documents regarding the implementation of GCG and other documents related to the valuation matters. For companies that have submitted the required documents in the previous CGPI, then the latest CGPI will provide a confirmation statement that the previous document is still valid. If a change occurs, the revised document should be attached. The document will be reviewed and analyzed and then grouped into seven parts representing governance structure, governance system, governance process, mechanism governance, governance output, governance outcome, and governance impact. Documents submitted include 'Anggaran Dasar', board charter for the Board of Commissioners, GCG Manual, Code of Conduct, Annual Report, Internal Audit Charter, Prospectus, Public Expose, and other documents requested by the assessment requirements.

The third stage of assessment is the Compilation of Papers, the compilation or preparation of papers is one of the fulfillment requirements that explains GCG implementation processes and programs in the company as well as management efforts related to the assessment matters. The paper describes the direction and focus of the assessment in accordance with the systematic guidelines of writing that have been set. Broadly speaking, the writing must meet the technical criteria which are in accordance with the writing format and fulfill the systematics of writing consisting of cover, validation sheet and content. For content, the papers should be arranged in orders, begin with an abstract which contains a brief description of the contents, then an introduction explaining the background, goals, objectives and benefits. After the introduction section, there should be the main chapter that explains the subject matter

according to the theme of the assessment of CGPI, then in the next section, there will be the section where the results achieved, and lastly, closed with the closing section.

The final stage of CGPI assessment is Observation, it is considered as one of the important parts of the research process and CGPI ranking in the form of a 'direct review' by the CGPI assessment team to ensure that the process of implementing a GCG implementation programs and management efforts is correlated to the assessment theme. The implementation of the observations was carried out in the form of presentations as well as question and answer (Q&A) discussions with the Board of Commissioners and Directors and other parties related to the company. In addition, the assessment team can verify the data and documentation needed for the sake of a more accurate CGPI assessment.

Regarding the results of CGPI Assessment, the results of the CGPI program ranking will use the assessment norms based on the range of scores achieved by CGPI participants with categorization of the level of quality of GCG implementation using the term "trusted". Hence, companies that get a score between 55.00% and 69.99% will get the title of a "fairly trusted" company. Companies that get scores between 70.00% and 84.99% will get the title of "trusted" company. And companies that get scores between 85.00% and 100% will get the award of "highly trusted" company. Additionally, the data on the results of the CGPI can be requested from the Indonesian Institute for Corporate Governance (IICG) and SWA Magazine as the organizer of the event.

**2.6. Hypothesis Development**

This section is aiming to propose a hypothesis that will be tested to answer the research question of this study. The development of the hypothesis is based on the corporate governance literature that has already been presented in the previous section.

Prior study by Moeljono (2005) defines Corporate Governance as the system that regulates and controls companies to create added value for all stakeholders. There are two things that are emphasized in this concept. Firstly, the importance of Shareholders' rights to obtain correct (accurate) and timely information, and secondly, the company's obligation to make disclosures accurately, timely and

transparently to company information, ownership and stakeholders. (Moeljono, 2005)

In the Epps and Cereola (2007) study of relations of corporate governance rating on the company's performance in 2002-2004, researchers were comparing the Institutional Shareholders Services (ISS) corporate governance quotient (CGQ) rating with two measurements of the company's operational performance namely ROA and ROE. The results show that no statistical evidence was found if the ISS corporate governance rating affects company performance.

Research from Klapper and Love (2003) shows that Good Corporate Governance (GCG) is highly correlated with asymmetric information and contracting imperfections that are represented by the composition of assets, growth opportunities, and company size. Companies with high level of good corporate governance (GCG) are commonly found in countries with weak legal systems. Good Corporate Governance (GCG) positively correlated with the company's operational performance as measured by ROA and market valuation as measured using Tobin’s Q.

Research conducted by Darmawati et al (2005) using a sample from 53 companies listed in the Stock Exchange Jakarta in 2001 and 2002, those companies are also included in the ranking list of good corporate governance implementation conducted by The Indonesian Institute for Corporate Governance (IICG). Using the regression model and ROE as the dependent variable, the result shows that only Good Corporate Governance (GCG) variables that can significantly affect ROE. Whereas, there is no control variable (asset composition, growth opportunity, and company size) that significantly affects ROE. And the regression model with Tobin’s Q indicates that both the Good Corporate Governance (GCG) variable and the control variable statistically do not affect company’s market performance.

Most prior researches can be related to Agency Theory, where the separation of ownership and differences in interests between principals and agents will create agency problems or conflicts of interest. From the concept above, the shareholder is recognized as the principal, and the company management is recognized as the agent. As the party that manages the company, the agent has more information about the company's capacity, company’s performance, work environment and the company as a whole. On the other hand, principals (shareholders) do not have enough

information about the agent's performance. This results in inequality of information between principals and agents called asymmetric information.

Companies that can implement good corporate governance practices are considered to have competitive advantages as well as reducing agency cost. With the increasing globalization of business and competition for capital, companies that can provide assurances that they are being appropriately managed can gain a competitive edge. Reducing perceived risks to investors can also reduce the cost of capital. The presence of an effective corporate governance system, within an individual company and across the economy as a whole, helps to provide a degree of confidence that is necessary for the proper functioning of a market economy. As a result, the cost of capital is lower and firms are encouraged to use resources more efficiently, therefore it can support the growth of the company. Particularly, the benefits obtained in implementing good corporate governance are varied, such as improving organizational performance through the creation of better decision-making processes, improving the operational efficiency of the organization, and improving services to stakeholders. The other benefits in terms of financing and investment in a company are namely, to simplify to obtain cheaper and non-rigid financing funds (due to trust issues) which will ultimately increase the value of the organization (corporate value), as well as to increase investors' trust and confidence to invest. By implementing good corporate governance, it is believed that it will lead to the good performance of the company, as it can be seen in the growth of the size of the company itself, whether it is reflected from its higher investment level or the increasing in sales. In addition, it is already explained before that Corporate Governance Perception Index (CGPI) plays a crucial role in this case. A company with a higher CGPI rating means that the company has been managed with transparency, accountability, responsibility, independency and fairness. Therefore, by achieving the award and acquire a predicate of highly trusted company, it is believed that the company will get a higher competitive edge as there will be an impact on the outputs of corporate performance implementation, contemplating that investors and creditors are proven to consider the CGPI rating for their investment decisions. Thus, from the theories and explanation above, the author will then develop the hypothesis as follows:

*A Good Corporate Governance implementation based on CG award is positively affect the company's financial performance.*