CHAPTER 2

THEORITICAL FOUNDATION

2.1 Corporate Governance

2.1.1 The Foundation of Corporate Governance

Development of corporate governance based on theories related such as *stewardship theory* and *agency theory*. In addition, various phenomena in finance that occurred in parts of the world also encourage the development of corporate governance. Corporate governance is growing rapidly because it is believed to have many benefits for those who apply.

2.1.1.1 Agency Theory

Agency theory is based on three assumptions (Eisenhardt, 1989), which are: human assumptions, organizational assumptions, and information assumptions. Human assumptions are categorized into three, namely: (1) *self-interest*, that is human nature that put self-interest; (2) *bounded-rationality*, that is human nature which has the limitation of rationality, and (3) *risk aversion* that is human nature prefers to avoid risk. Organizational assumptions are categorized into three, namely: (1) convix as a goal among participants, (2) efficiency as an effectiveness criteria, and (3) information asymmetry between the owner and agent. Information assumption is the assumption stated that information is a commodity that can be bought. Agency theory is more emphasis on the determination of efficient contractual arrangements

in relation to the owner with an agent. Efficient contract is contract that is clear to each party which contains about the rights and obligation, so as to minimize the agency conflict.

The separations' concept of ownership of the shareholders and control the management is something that has become critical attention in the company. The shareholders (investors) are the parties who provide funds for the activities of the company and have the right to benefit the company without having to be responsible for the operational activities of the company. The management act to execute the operational activities of the company without having to be responsible for the availability of funds for companies. However, both parties certainly have their respective interest which could lead to the existence of conflicts of interest. Herbert (1959) found that managers has tendency to be risk averse than maximizing profit in terms of achieving acceptable level of growth to their own existence in the company (Baysinger and Hoskisson, 1990). Based on RUPS (annual shareholders meeting), the investor designating a party which serves to control the actions by management. In Indonesia, this party was named commissioner. The Board of Commissioners appoints the professional people to run the operational activities of the company named *Board of Directors*. The shareholders delegate decision-making authority to the CEO, with the expectation that the agents will act in their best interest.

Based on the above exposure, it is clear already that the separation of the company managers with the owner of the company intended to allow the owner of the company (principal) to gain the maximum possible benefits with the most efficient cost by handing over the maintenance of daily business in the management.

It is underlying agency theory that explains that the board of commissioners, a party who represents shareholders, rationally will act to represent their own interest. Supposedly, each actions and policies that they are fully committed for the benefit of the shareholders, because they are appointed to represent the shareholders in control functions. As well as with the agent, the discretion of the company's management to optimize corporate profits could lead to a process of maximizing the agent's personal interest with the cost and the load that should be borne by the owner of the company. The other difference is that the principal focus more on the company's long-term growth, while the agent are often just give priority to short-term profits.

The existence of differences of interests leads to the agency cost, which is the cost of surveillance covered by shareholders to monitor the management. This cost including cost for holding audit system that could limit the behavior of management, costs to ensure that there is no misapplication of authority. Conflict that give rise to agency cost is getting worse when corporate ownership is widely distributed that caused the owner more difficult to exercise the effective control against the management that manage the company.

This separation also causes a lack of transparency in the use of funds at the company. Therefore, it required a control system to prevent the potential abuse of power. The concept of corporate governance arises as an effort to prevent and overcome management behavior that prioritizing on self-interests, by creating mechanisms and control devices that enable to achieve sense of optimal for all parties, management, shareholders, and other interested parties to create efficiency for the company.

2.1.1.2 Stewardship Theory

According to James H. Davis, F. David Schoorman, and Lex Donaldson (1997), *stewardship theory* defines situations where managers are not motivated by individual goals, but by their principal purpose. An understanding of the characteristics of manager and the situation is essential to understand the interests of manager principal.

Stewardship theory is focused on the possible structure of a higher manager (Donaldson and Davis, 1989, 1991, 1994; Fox & Hamilton, 1994). For example, Donaldson and Davis (1991) argued that the CEO who is a steward, the act of supporting organization is the best facilities when the corporation has a strong structure that will give them a high authority and secure. This situation is achieved more real if the CEO's seat on the Board of Directors. This structure can be viewed as dysfunction on the theory of agency model of man. However, on *stewardship of man* model, stewards maximize its utility as they achieve the organization goals than their self-serving goals.

From the explanation above can be drawn the conclusion that the stewardship theory is more based on the theory of psychology and sociology, where managers were motivated to do and behave collectively for the benefit of the organization, so that the cooperation of all members of the organization constitutes the main characteristics of *stewardship*.

2.1.2 The History of Corporate Governance Development

The rise of corporate governance cannot be separated from some occurrence in parts of the world that shook the economy.

I. Cadbury Committee

The term *Corporate Governance* was first introduced by the Cadbury Committee in 1992 that use the term in their report which is currently known as the Cadbury Report. Cadbury Committee was commissioned by the Conservative Government of the United Kingdom in May 1991, with scope of duties in the form of financial aspects and corporate governance (The Report of the Committee on the Financial Aspects of Corporate Governance, 1992, 1.8). This committee is chaired by Sir Adrian Cadbury. On December 1992, the committee issued its report that only be used by all sides namely *The Code of Best Practice*. This report presents the committee's recommendation on company's structure and responsibilities of the Board Director. Two key recommendations contained within are that the boards of public companies, including at least three non-executive boards (outside) and that the position of President Director (CEO) and Chairman of the Board of the company mandated in different individuals. The reasons underlying the committee recommendation is that the greater independence of corporate boards will improve the quality control (Dahya, McConneli, & Travlos, 2002).

The next significant contribution was a report by the Greenbury (1995) and Hampel (1998). Both reports are incorporated in "Principles of Good Corporate Governance and Code of Leading Practice (Combined Code)" published by the London Stock Exchange. Besides Cadbury, Greenbury, and Hampel, many parties are also contributing to provide a foundation for the determination of the standards. In 1997, Turnbull also made the *Turnbull*

Guidance on the application of corporate governance guidelines. All these regulations are combined and after the compilation of *Combined Code*, various organizations that dabbling in the field of *Corporate Governance* on the other side of the world also began actively to set standards for their respective countries, where such standards are adapted to the conditions in the country (Wallace & Zinkin, 2005)

II. Crisis of Asia-Latin America

The era of free market is characterized by the formation of the World Trade Organization (WTO) in 1994; followed by the first financial crisis experienced by Mexico (1995), then the financial crisis of Thailand (1997), and then turned became the financial crisis in Asia because soon hit other Asian countries such as Indonesia, Malaysia, Japan, Korea, Hongkong, and Singapore. The crisis is known as Asia-Latin America crisis.

To deal with the bad condition, the Indonesian government needs an injection of fresh funds. Then, the International Monetary Funds (IMF) came to bring help. This institution offers conditional assistance. They delight in providing loans as long as the government of Indonesia willing to fulfill several requirements. One of them is a commitment to improve corporate governance system (Kurniawan & Indriantoro, 2000). From the history perspective, the appearance of corporate governance in Indonesia is not based on local initiative. The concept was born in Indonesia because the command of outsiders (IMF). Indonesia adopted corporate governance based on IMF, because there is no other option to be able to get out of financial crisis at that time (Kamal, 2011).

2.1.3 Definition of Corporate Governance

Corporate governance is becoming an important issue and gets various parties attention. To be able to engage in the practice of *good corporate governance*, then it required an understanding of the implementation of good corporate governance itself. In its development, there are several definitions of corporate governance. Currently, there is no single definition of corporate governance (Solomon, 1999). Here are some definitions of corporate governance provided by several parties, including:

According to Cadburry Committee in the Cadburry Report (1992), corporate governance described as,

> "*Set of rules that define the relationship between shareholders, managers, creditors, government employees, and those other interested parties both internal and external with respect to their rights and responsibilities*"

Indonesian Institute of Corporate Governance (IICG, 2000) defined corporate governance as,

> "*the process and structured used to direct and manage the business and affairs of company towards enhancing business prosperity and corporate accountability with the ultimate objective of realizing long-term shareholder value, whilst taking into account the interest of other stakeholder*"

According to Organization for Economic and Development (OECD, 2004):

"*Corporate Governance involves a set of relationship between a company's management, its board, its shareholder and other stakeholder... and... provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined.*"

World Bank President, J. Wolfensohn (Financial Times, 2009) stated that "*corporate governance is about promoting corporate fairness, transparency, and accountability.*"

Australia Securities Exchange (ASX, 2007) highlights a broader understanding about corporate governance, "*The framework of rules, relationships, systems and processes within and by which authority is exercised and controlled in corporations. Corporate governance influences how the objectives of the company are set and achieved, how risk is monitored and assessed, and how performance is optimized. Effective corporate governance structures encourage companies to create value, through entrepreneurialism, innovation, development and exploration, and provide accountability and control systems commensurate with the risks involved.*"

2.1.4 The Principles of Good Corporate Governance

The OECD Council Meeting at Ministerial level was held in 1998; generate discussion to develop the OECD Principles of Corporate Governance. In 1999, the Principles were formed and adopted as a benchmark for corporate governance initiatives in both OECD and non-OECD countries. After a survey conducted by OECD Steering Group in 2002, it was concluded that the 1999 Principles should be revised in order to view the new development and concern considerations. The

revised version was published in 2004. Below reveals the six principles according to OECD Principles of Corporate Governance:

I. <u>Ensuring the Basis for an Effective Corporate Governance Framework</u>

"The corporate governance framework should promote transparent and efficient markets, be consistent with the rule of law and clearly articulate the division of responsibilities among different supervisory, regulatory and enforcement authorities." (OECD, 2004)

II. <u>The Rights of Shareholders and Key Ownership Functions</u>

"The corporate governance framework should protect and facilitate the exercise of shareholders' rights." (OECD, 2004)

III. <u>The Equitable Treatment of Shareholders</u>

"The corporate governance framework should ensure the equitable treatment of all shareholders, including minority and foreign shareholders. All shareholders should have the opportunity to obtain effective redress for violation of their rights." (OECD, 2004)

IV. <u>The Role of Stakeholders in Corporate Governance</u>

"The corporate governance framework should recognize the rights of stakeholders established by law or through mutual agreements and encourage active co-operation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises." (OECD, 2004)

V. <u>Disclosure and Transparency</u>

"The corporate governance framework should ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership, and governance of the company." (OECD, 2004)

VI. The Responsibilities of the Board

"The corporate governance framework should ensure the strategic guidance of the company, the effective monitoring of management by the board, and the board's accountability to the company and the shareholders." (OECD, 2004)

There are also principles of corporate governance under *Pedoman Umum Good Corporate Governance* issued by KNKG in 2006, specifically:

I. Transparency

To maintain objectivity in performing business, the company must provide material and relevant information in a way that is easily accessible and understood by the stakeholder. Company should take the initiative to disclose, not only the problem that is required by laws and regulation, but also the things that are important to decision making by shareholders, creditors, and other stakeholders. (KNKG, 2006)

II. Accountability

Company should be accountable for its performance in a transparent and fair. For that the company should be properly managed, measurable and in

accordance with the company's interests while taking into account the interests of shareholders and for stakeholders. Accountability is a necessary prerequisite to achieve sustainable performance. (KNKG, 2006)

III. Responsibility

Companies must comply with legislation and undertakes responsibilities for people and the environment so that business continuity can be maintained in the long term and gained recognition as a good corporate citizen. (KNKG, 2006)

IV. Independency

To accelerate the implementation of the principles of good corporate governance, companies must be managed independently so that each organ in a company does not dominate each other and could not be intervenced by another party. (KNKG, 2006)

V. Fairness

In carrying out its activities, the company must always pay attention to the interests of the shareholders and other stakeholders based on the principles of fairness and equality. (KNKG, 2006)

2.1.5 Corporate Governance Mechanisms

Dariyah (2010) stated that Good Corporate Governance mechanisms is a set of organ company that runs the management function, supervision and control of the company to achieve the expected objectives without ignoring the interests of other stakeholders. The GCG mechanisms or structure consists of a main organ that is

general meeting of shareholders, the board of commissioners and the board of directors as well as other supporting organs includes audit committee, corporate secretary, function of risk management, compliance and so forth that is adapted to the needs of the company.

Figure 2.1

The Structure of Board of Commissioner and Board of Director in Two Tiers System Adopted by Indonesia

(Source: FCGI, 2000)

In the model two tiers system, RUPS or General Meetings of Shareholders is the highest structure that has the authority to appoint and dismiss the board of commissioners representing shareholders to perform the function of control over management.

The system also received affirmation in Pasal 13 UU BUMN that determined *Organ Persero* is:

1. RUPS,
2. Directors,
3. Commissioners.

2.1.5.1 General Meeting of Shareholders

General Meeting of Shareholders (RUPS) is the highest board in an enterprise. According to *Pasal 1 ayat (4) Undang-Undang Republik Indonesia No.40 Tahun 2007*, RUPS is *Organ Perseroan* that has the authority which is not given to the board of directors or board of commissioners within the limits specified in this law and/or the articles of association. The authority minister act as the General Meeting of Shareholders in respect of all shares owned by the state and refines the act as shareholders at *persero* and limited liability in case of not entirely owned by the state. Some authority of RUPS as regulated in *UU No.40 Tahun 2007* among others:

1. The amendments to the articles of association (*Pasal 19*);
2. The reduction of capital (*Pasal 44*);
3. Examination, approval and ratification of the annual report (*Pasal 69*);
4. Determination of the use of income (*Pasal 70*);
5. The appointment and dismissal of directors and commissioners (*Pasal 94, 111,* and *119*);
6. Determination of merger, consolidation, and acquisition (*Pasal 127*);
7. Determination of the dissolution of the company (*Pasal 142*).

2.1.5.2 Board of Commissioners

Pasal 1 ayat (5) UU No.40 Tahun 2007 stated that is an organ of the company in charge of conducting surveillance in general and/or specialized according to the articles of association as well as give advice to the board of directors. The Board of Commissioners, that is more than one person, as the council, a member of the Board

of Commissioners cannot act independently to represent the company, but based on the decision of the Board of Commissioners (*Pasal 108 ayat (4)*).

The terms of appointment of commissioners as set forth in *Pasal 110 UU No.40 Tahun 2007*, is an individual who has the capability in performing legal action, except within 5 years before his appointment as ever: a. declared bankrupt; b. become a member of the board of directors or the board of commissioners who were convicted cause a company declared bankrupt; or c. had been sentenced for a criminal offense which caused financial loss to the state and/or relating to financial sector.

Some obligations of the Board of Commissioners stated in *UU No.40 Tahun 2007 tentang Perseroan Terbatas* are:

1. Pasal 114 ayat (2) declared that each member of the board of commissioners obligated with good faith, prudence, and are responsible for carrying out tasks according to the tasks of supervision and provide advices to the board of directors;
2. The Board of Commissioners is obliged to: a. make a note of the meeting of the Board of Commissioners, and keep a copy of it; b. report to the company regarding the ownership of its shares and/or his family at the company and another company; and c. give a report on the surveillance tasks that have been performed within the previous accounting year to the RUPS (*Pasal 116*).

Independent Commissioners

Regarding the composition of the Board of Commissioners, it required the existence of independent party who became a member of board of commissioners. Below shows the criteria of Independent Commissioners according to FCGI (2006, p. 6):

1. The independent commissioner is not a member of the management;
2. The independent commissioner is not a majority shareholder, or an official of or in any other way related directly or indirectly with the majority shareholder of the company;
3. Independent commissioner within the last three years not employed in its capacity as of executives by the company or other firms in one business group and nor is employed in its capacity as commissioner after no longer occupy such positions;
4. Independent commissioner is not a professional advisor of the company or other companies that one group with the company;
5. Independent commissioner is not a supplier or a significant and influential customers of the company or other companies of the group;
6. Independent commissioner have no contractual with corporation or other one group corporations other than as commissioner of the corporation;
7. Independent commissioner must be free of interest and affairs of any business or any other relationship which could, or could reasonably be considered as materially interfere with his ability as a commissioner to act in the interest of a profitable company.

2.1.5.3 Board of Directors

Understanding of directors according to *Pasal 1 ayat (5) UU No.40 Tahun 2007 tentang Perseroan Terbatas* is the organ of the company that has authority and full responsibility to manage the company for its interests, in accordance with the purposes and objectives of the company as well as to represent the company, either in or out the court in accordance with the provisions of the articles of association.

Directors perform the management of the company for its interest in accordance with the purpose and objective of the company (*Pasal 92 ayat (1)*) and directors authorized to run the management in accordance with the policy that is considered right, within the limits specified in this law and/or the articles of association (*Pasal 92 ayat (2)*). According to *Pasal 92 ayat (3)*, the company's board of directors consists of one or more member of directors. Further explained the company which fronts their business exert public funds, the company which issued a debt acknowledgement or an issuer must have a minimum 2 (two) members of the board of directors (*Pasal 92 ayat (4) UU No.40 Tahun 2007*).

The requirements become directors as stipulated under *Pasal 93 ayat (1) UU No.40 Tahun 2007* is an individual who has the capability in performing legal action, except within 5 years before his appointment as ever: a. declared bankrupt; b. become a member of the board of directors or the board of commissioners who were convicted cause a company declared bankrupt; or c. had been sentenced for a criminal offense which caused financial loss to the state and/or relating to financial sector.

2.1.5.4 Audit Committee

There are some definitions towards audit committee, including:

According to Sarbanes-Oxley Act (SOX) section 205(a), audit committee described as,

> "a committee or (equivalent body) established by and amongst the board of directors of an issuer for the purpose overseeing the accounting and financial

reporting processes of the issuer and audits of the financial statement of the issuer."

Manual Audit Committee IKAI (*Ikatan Komite Audit Indonesia*) defined audit committee as,

"A committee worked professionally and independently established by the Board of Commissioners, thus its tasks are to assist and strengthen the function of the Board of Commissioners in performing the function of supervision (oversight) or process of financial reporting, risk management, the implementation of audit and corporate governance in the company."

In Indonesia, there are regulations concerning audit committee, which are:

1. Guidance Good Corporate Governance (March, 2001) that recommends all companies in Indonesia have an audit committee.
2. *Surat Edaran BAPEPAM No. SE-03/PM/2000* that recommends public companies to have audit committee, as well as updated with *Keputusan Ketua BAPEPAM No. Kep-41/PM/2003* on 22th December 2003 about *Peraturan Nomor IX.1.5 : Pembentukkan dan Pedoman Pelaksanaan Kerja Komite Audit*.
3. *Kep. 339/BEJ/07-2001*, that requires all companies listed in Jakarta Stock Exchange have an audit committee.
4. Keputusan Menteri BUMN No. KEP-103/MBU/2002 that requires all state-owned enterprises have audit committee.

In accordance to *BAPEPAM-LK No. IX.1.5* about "Pembentukan dan Pedoman Pelaksanaan Kerja Komite Audit", duties and responsibilities of audit committee include:

1. Review the financial information issued by the company.
2. Review the company's obedience of legislations in the capital market and other regulations.
3. Review over the inspection by the external auditors.
4. Reported to the commissioners various risks faced by the company and the implementation of risk management by the board of directors.
5. Review and report to the commissioners upon complaint relating to issuers.
6. Maintain the confidentiality of the data, documents, and company information.

2.1.6 Benefits of Implementing Corporate Governance

Corporate governance has an important role in the business, and it is worth to bring up the benefits of *Good Corporate Governance*. These are the benefits of *Good Corporate Governance* implementation refer to The Indonesian Institute for Corporate Governance (IICG, 2000), namely:

1. *Minimize the agency cost*. Agency cost is the fees that arise because the delegation of shareholder's authority to the management, for example in the form of monitoring.
2. *Minimize cost of capital*. Company that is well-governed will create a positive reference for creditor, so that it will minimize the capital cost which should be borne if the company proposes for a loan.
3. *Increase the value of company shares*. Company that is well-governed will attract investor's interest to invest its capital in the related company for long periods of time.

4. *Lift up the corporate image*. Corporate image is very important to build trust, as well as for investor, creditor, and the government.

According to International Finance Corporation collaborate with U.S. Department of Commerce in 2004; there are also four advantages of implementing *Good Corporate Governance*. Some of them have similar ideas with the IICG point of view. The additional idea is that GCG can *stimulate performance and improve operational efficiency* (IFC, 2004). A well-governed company will leads to accountability system betterment, also decreasing the risk of fraud. In which there will be improvement in management and executive performance. This creates preferred condition in term of sustaining the company's long-term development.

2.1.7 Corporate Governance in Indonesia

In 1997, Asia experienced a prolonged economic crisis, which impacting on the Indonesian company. At the end of 90's, countries affected by the crisis in Southeast Asia began to experience recovery, except Indonesia (Kaihatu, 2006). One of the things that aggravate the economic crisis that afflicting Indonesia is most companies in Indonesia have not implement good corporate governance yet. To deal with adverse condition, Indonesian government needs fresh funds. Then, the International Monetary Funds (IMF) came to bring help. This institution offers a conditional assistance. They will provide the loans, as long as Indonesian government willing to meet some of the requirements. One of them is a commitment to improve the system of corporate governance (Kurniawan & Indrianto, 2000; Kamal, 2011). At that time, from the IMF point of view, the corporate governance system in Indonesia was one of the weak points of the economic development in Indonesia. In the end, Indonesia

agreed to all the requirements that put forward by the IMF. Finally, Indonesia received a lot of fresh funds. Viewed in terms of history, the existence of corporate governance in Indonesia is not based on local initiatives. This concept is applicable in Indonesia because the orders of outsiders namely IMF. Indonesia decided to adopt this system because there is no other option to get out of the financial crisis at that time.

Regarding those subject, the government took strategic measures, such as BUMN privatization and reform of GCG. Currently, Indonesia had many rules of good corporate governance; among them is UU No.17 year 2003 about *State Finances* and UU No.19 year 2003 about BUMN (state-owned enterprises). Moreover, the commitment to realize the GCG is begun, either by the government, Bank of Indonesia, as well as the private sector. There are also evidenced by the establishment of the KNKG (national committee on governance), the establishment of audit committees for BUMN, the birth of the Forum for Corporate Governance in Indonesia (FCGI), and so forth.

In 1999, Indonesian government established a corporate governance committee in order to create a code of corporate governance. This committee, namely the National Committee for Corporate Governance, was formed through Coordinating Minister of Economics, Finance, and Industry. The committee successfully compiled Code for Good Corporate Governance in early 2000 (Daniel, 2003). This code applies to all of the companies listed in Indonesia Stock Exchange as well as state-owned enterprises (Lukviarman, 2004). Then, in 2006, the committee revised the previous code into *Indonesia's Code of Good Corporate Governance*.

The overview of *Indonesia's Code of Good Corporate Governance* that has been published by National Committee on Governance in October 2006 will be outlined below.

I. <u>Create a Conducive Situation to Implement Good Corporate Governance</u>

This code introduces "inter-related pillars", namely the government as regulator or policy makers, the business community as market participants, and the public as users of the results of the products and services from the business community (National Committee on Governance, 2006)

II. <u>The Principle of Good Corporate Governance</u>

Transparency, accountability, responsibility, independency, and fairness which are already discuss on the previous page.

III. <u>Business Ethics and Code of Conduct</u>

This code suggest the company to have a set of guidelines for behavior that would become a reference for the organs of the company and employees in implementing corporate values and business ethics, which are expected to become a part of corporate culture (National Committee on Governance, 2006).

IV. <u>The Organ of the Company</u>

Indonesia runs a two-tier system. Therefore, the three organs, namely the general meeting of shareholders, board of commissioners and board of directors, must exist within a company. It is believed that each organ has a key role in implementing the principles of corporate governance (National Committee on Governance, 2006)

V. <u>Shareholders</u>

Generally, this code states that as the owner of the company, shareholders must pay attention to the rights and responsibilities within the company in accordance with the law and other rules as well as the company's base budget (National Committee on Governance, 2006).

VI. Stakeholders

Stakeholders are those who have an interest to the company and get influence directly by the company's operational and strategic decisions, including employees, business partners, and society (National Committee on Governance, 2006).

VII. Statement on the Application of GCG

This code is adopting voluntary system. Voluntary system is where the company is permitted to not adhere to the principles provided by the code maker as long as the company described the options (National Committee on Governance, 2006).

VIII. Practical Guidelines for Implementation of GCG

The code declares that the implementation of corporate governance needs to be done systematically and continuously. Therefore, companies need practical guidelines as a reference in applying corporate governance. Practical guidelines are at least containing the following: vision, mission, and corporate values; positions and functions of its organs; policy to ensure the functions of each organ of the company runs effectively; policy to ensure the success of accountability, effective internal control, and the proper financial reporting; code of conduct based on corporate values and

business ethics; means of disclosure of information for shareholders and other stakeholders; and policy refinement of various company regulations in order to meet the principles of good corporate governance (National Committee on Governance, 2006).

2.2 Corporate Disclosure

To be more competitive in the current era of global competition, companies are faced with condition to be more transparent in disclosing information of the company. Disclosure of company information can be done with the main accounting product, which is financial statement. Veronica and Bachtiar (2003) stated that financial reports are one source of information used to assess the financial position and performance of the company. On uncertainty condition over the market, the value of relevant information and reliable reflected in the disclosure of the company becomes important factor. Disclosure of the detail will give an idea of performance and actual operation of the company (Sidharta & Juniarti, 2003). This kind of disclosure which will give rise to trust from the stakeholder, particularly in this case is the lender, regarding the performance of management and company capabilities (Sidharta & Juniarti, 2003). In addition, according to Bill Rees (1990), disclosure quality could help the lenders and risk underwriters in estimating the risk of failure that will be charged to the company.

2.2.1 Definition of Disclosure

In part one of the principles of financial accounting, the term disclosure associated directly with the financial statement. In fact, it turns out that disclosure is also associated with other information outside the financial statement. Disclosure is an important tool to reduce the asymmetry of information between the managers with the owner of the company. Evans (2003) defines a disclosure as follow:

"Disclosure means supplying information in the financial statement, including the statements, and the supplementary disclosures associated with the statements. It does not extend to public or private statement made by management or information provided outside the financial statement."

According to Hendriksen and Breda (1992), disclosure is defined as "*the provision of information required for the operation of optimally efficient capital markets.*"

2.2.2 The Purpose of Corporate Disclosure

The main purpose of disclosure is to provide information needed to make decision by the concerned parties. Reverse to Hendriksen & Breda (2000), the objective of disclosure is as follow,

"*Provide information that is significant and relevant to the user of financial report to help them make decisions in the best possible way with the restrictions that the benefits must outweigh the cost.*"

Meanwhile, according Suwardjono (2004) disclosure purposes is as follows,

1. Protecting Purposes

The purpose of protection is predicated on the idea that not all users sophisticated enough so that the naive users need to be protected by disclosing information that they might not get. In other words, disclosure is intended to protect the management handling that may be less fair and less open.

2. Informative Purposes

The disclosure is directed to provide information that can help the effectiveness of user's decision making. This objective is usually underlying the formulation of accounting standards to determine the level of disclosure.

3. Special Needs Purposes

This purpose is a combination of public protection and informative purposes. What should be disclosed to the public is limited to what is considered beneficial for the intended user temporarily for the purpose of supervision. Certain information must be submitted to the board of trustees pursuant to regulation through forms that contain disclosures in detail.

2.2.3 Type of Disclosure

The information disclosed in the financial statements can be grouped into a *mandatory disclosure* and *voluntary disclosure*. Information that is mandatory disclosure is information which must be disclosed in the financial statement as required by regulation or legislation. While the voluntary disclosure is the submission of information voluntarily that is provided by companies outside the mandatory disclosure. Meek et al. (1995) stated "In the context of voluntary disclosure, management companies are free to choose to give other accounting

information that is considered relevant in support of decision making by the user of the annual report." Management considerations to disclose information voluntarily is influenced by factors of cost and benefits. Based on Elliott et al. (1994), the main benefits obtained from voluntary disclosure is the low cost of capital.

2.2.4 History of Corporate Disclosure

Most public companies' disclosure practices reflect the realities of the pre-1995 business and regulatory environment. At that time, there were real and substantial legal risks associated with making forward-looking statements about a company's financial performance. The allegation usually was that the company made optimistic public statements and knew the statements were incorrect or the statements had become invalid and the company failed to publicly correct or update them.

In 1995, The Private Securities Litigation Reform Act curtailed the abusive practice of filing class action lawsuits against public companies with no more evidence than a sharp drop in stock price. The new law also provided a "safe harbor for forward-looking statements" to encourage companies to provide prospective corporate information without fear of litigation. Rather than openly disclose their expectations for the future, most public companies took an evolutionary approach and simply increased the amount of guidance they gave to analysts and institutional investors. This information typically was disclosed during closed analyst briefings and earnings conference calls that served as private conduits where management shared valuable information about future performance only with professional investors.

In 2000, Regulation Fair Disclosure (RFD) stopped this flow of privileged information. The new law required that companies disclose material information

simultaneously to all parties whether analysts, professional and individual investors, or the media.

In addition to these regulatory changes, the Internet has brought about enormous advances in communications technology since 1995. Prior to the Internet, the only effective means for disseminating corporate information such as earnings forecasts was through private networks such as Bloomberg, First Call, and Reuters. Today, the Internet makes information freely available to everyone simultaneously, putting the real "Fair" in Fair Disclosure. Yet the distribution vehicles of the past persist.

2.2.5 Corporate Disclosure in Indonesia

Recently, government imposes several laws concerning corporate disclosure in accordance to the needs of information disclosure. In Indonesia, corporate disclosure is regulated under *Keputusan Ketua Pengawas Pasar Modal dan Lembaga Keuangan No: KEP-134/BL/2006 rules No: X.K.6*. This regulation basically define the structure of annual report and the contain itself. This regulation must be followed by every company listed in Indonesia Stock Exchange (IDX) in preparing the annual report. The regulations consist of the report's format, components, and its due date of reporting. There are several components regulated by BAPEPAM-LK which is compulsory for company to be included in the annual report.