CHAPTER II
THEORETICAL FRAMEWORK AND HYPOTHESIS

2.1 Firm performance

Firm Performance defined as display of a situation as a whole over the company for a certain period of time, is a result or achievement that is influenced by the company's operational activities in how to utilizing the resources that I have owned. (Helfert, 1996). Profitability is mentioned to be have a typical relationship with firm performance which is viewed from a financial perspective. If company's strategy viewed from a financial perspective, in the long term will affected shareholder value.

Firm performance also defined as determination of certain measures that can read the success of a company in generating profits (Sucipto, 2003). Performance appraisal is the periodic determination of the operational effectiveness of an organization, parts of the organization and employees based on predetermined targets, standards, and performance. Company performance assessment can be seen in terms of financial statement analysis and in terms of changes in stock prices. The performance appraisal is used by managers for things like:

1. Make sure of managing the organization's operations efficiently and effectively undergo by maximizing employees;
2. Assisting the decision making concerned with employees such as bonus, advancement, transfer, and termination.

3. Provide training and development needs of employees. Providing selection and evaluation criteria for employee education programs;
4. Providing feedback for employee about how their supervisors scoring their performance;
5. Providing a basis for distribution to assess their performance.

Gonzalez and Meca (2013) explain that weak governance structure companies can provide opportunities for managers to engage in behavior that can ultimately result in lower quality reported earnings, which is a strong indication in business ethics. Companies are said to develop can be measured by getting the maximum profit and with the lowest possible cost. Many ways can be done to realize it, where sometimes decision-makers ignore some vital aspects such as the satisfaction of empowered human resources, the relationship between company management and shareholders, and the company's share ownership structure. These factors affect company performance so that it reflects weak corporate governance. (Farida, Yuli & Eliada, 2010). Firm performance is the dependent variable in this study. From previous studies, it can be concluded that this dependent variable can be measured through several aspects contained in the company, among others.

2.2 Corporate Governance

A company director who has to issue and manage finances that do not belong to him, may not have the full attention or focus on how to safeguard the money. Feelings of anxiety experienced are different from directors in private companies who look after their own money (Smith, 1976).

The Indonesian Institute for Corporate Governance (IICG) stated that purpose of Corporate governance is for giving more value for the corporation which is actually process, system and structure that done by company department that giving company more value especially in a long term. Structure is one unity which is there is combination of board director, board of independent and stakeholder. System is a basic operasional for check and balances as a reponsibility for management corporation. Process is a way for make sure that corporate governance is implement well for obtain goal, purpose and expected firm performance.

Corporate governance has some point to follow if a company want to apply into their company, which is :

a. Fairness, Guarantee for protect every right of every shareholder of the corporation, and the board of directors should treat all stakeholder fairly and equitably

b. Transparency, To obligate transparency of every information, timely, and also in accurate manner and can be compared with other, which s related to the matter of company financial condition, corporate governance, and information about the ownership of company

c. Accountability, which is explain about roles and responsibility and supporting roles for guarantee the balance of management and shareholder, which is supervised by board of director.

d. Responsibility, to make sure every rules still obeyed by every people that has relation with corproation activity which is as the way to show they also obeyed social value

e. Independency

Every department of corporation should be managed by independent so that in each part would not have double work or same purpose and would be intervention by other department

Implement of Corporate governance in a long time is expected to make and maintain financial condition to be good in long time. If there is a good corporation governance it could increase corporation entity efficiency, increase public trust in corporation, maintain corporation going concern aspect, could measure corporation target for obtain firm performance, increase productivity, and decrease management risk (Sunarto, 2003).

Corporate governance already implemented in company in Indonesia. And research that are done by Pratama who was doing research in a plastic corporation in Indonesia, the conclusion is that practically corporate governance in Indonesia still not implemented really well.

Gonzalez and Meca (2013) explained if a company has a weak corporate governance system it could giving a chance for manager for involved into an action which is can give an effect of decrease of firm performance.

2.3 Previous Research

Several previous studies have conducted research about the application of corporate governance to firm performance of company such as Hermalin and Weisbach (1991), Ongore, K'Obonyo and Ogutu (2011), Darmadi (2011), Tornyeva and Wereko (2012), Amer, Ragab and Shehate (2014), Bebeji, Mohammed, and Tanko (2015), Rajput and Bharti (2015) and Senthuran and Velnampy (2015).

Hat et al (2008) doing a research discussing the connection among good corporate governance toward firm performance. From that research, Hat et al using variable such as timelines and disclosure as the intervening variable . The result of that research showing no significantly result between the implementation of corporate governance toward timelines and disclosure. And also through this research found out there is also no significantly effect from timeliness and disclosure to firm performance. But, there is a conclusion that firm performance was effected by the implementation of good corporate governance.

Hardikasari (2011) also doing the same research but using banking as the object of the research. The mechanism indicator that used in this implementation of corporate governance reserach is number of BoD, number of Commissioners, and also the size of the company toward the earning management that did by banking industry in Indonesia. Sample that used in that research is bank sector company that published in Indonesia Stock Exchange (IDX) FROM 2006 – 2008. The result of this reseach is size of Board of Director giving a negative effect by significant toward firm performance and size of company giving positive effect but not siginificant towards financial performance.

Siam, Laili, and Khairi (2014), Ugbede, Lizam and Kaseri (2013), also Iraya et al (2015) doing research concerning the impact of corporate governance for firm performance. Elbarrad (2014) doing a research to searching the relationship between disclosure in annual reports as outlined in the corporate governance regulations imposed by Saudi Arabia Authority and firm performance in Saudi Arabia. This research are focuisng on three sectors which is Cement, Banking, and Multi-Investment companies to measure the relationship between

those variables and company performance measured by three measure, such as Return on Asset (ROA), Return on Equity (ROE) and Price to Earnings (PE). And the result of the research is in banking sector corporate strategy and social responsibility found significantly positive effect on ROE, while disclosing the market share found significantly positive effect on ROA. This confirm results achieved by Nuryaman (2012) that mentioned there is positive effect between corporate governance and firm performance.

Board composition on company performance has been examined by Hermalin and Wesbach (1991) by using the variable board of directors size. This research was then continued by Hong and Nguyen (2014), Velnampy and Nimalthasan (2013), Senthuran and Velnampy (2015) by adding the diversity of boards of directors, councils, meetings of board ownership boards and independent commissioners.

Research conducted by Ngurah and Merta (2016), testing the influence of leverage, company size, and profitability on firm performance. The sector company of this study was food and beverage companies on IDX in the period 2011-2014, which amounted to a total of 16 companies. In this study it can be concluded that company size has a significant positive on firm value, leverage has a positively effect on firm value, and profitability found to be have a positive effect on firm value.

Suryani (2010) in examining the influence of leverage ratios, liquidity ratios and firm size toward firm performance obtained from samples of companies belonging to the Jakarta Islamic Index (JII) group in 2004-2008. The dependent

variable was company performance and the independent variable is leverage, liquidity, and firm size.

Azeez (2015) examined the relationship among corporate governance and company performance in Sri Lanka. Data were obtained from the annual report of 100 companies listed on the Colombo Stock Exchange on the period 2010-2012. The measurement of company performance is EPS, ROA, ROE with independent variables used are board size, CEO duality, and board independence. Control variables are company size, leverage, and company age.

Amidu (2007) studied the effect of dividend policy in the company performance at Ghana companies. The sample used is the financial statements of companies listed on the Ghana Stock Exchange for eight years, from the period of 1997-2012 which amounted to 25 companies. This study uses dividend policy variables, payout ratios, and including company size, leverage, and sales growth as the control variable.

Chugh, Meador, and Kumar (2012), studied the influence of corporate governance and firm performance on companies in India. Performance measurement of companies that use ROA and ROE take samples from companies listed on the Indian National Stock Exchange. Board size, board independence, CEO duality, and company size used as the variable of this studies.

There are also previous studies conducted by Ehikioya (2009), Vo and Phan (2013), Andreou et al. (2014), and Yoo and Jung (2015), regarding the influence of good corporate governance on financial performance, the selection of

independent variables and controls based on the criteria that are minimum in two studies, and continued by Tranggono (2017) and used independent variable which is director size, outside commissioner, stockholder ownership, and director ownership and firm size, firm's age, cash holding, and leverage as the control variable.

2.4 Independent Variable Effect on Dependent Variables

2.4.1 Board Size and Firm Performance

The directors had a duty to hold the company management in accordance to any policy that appropriate by Indonesian Company Law or AoA. Overally meeting of the board is including from appointing, replacing until dismissing members of the company. Also making regulation and strategic of the company source for short-term until long-term period. The appoinment of the directors also mentioned in the Indonesian Company Law. In PT (Limited Liabilty Company) should at least have one director.

In case, company want to have 2 director so one of them should be title as president director. There will be a separation of management task and responsibility. Especially in some case like for taking care of within company or outside of company. The number of director could be giving effect of how long it takes to making decision in the company. One of the reason is because of some directors should have good coordinations within each other. When postponed a making decisions could be lead to reducing the firm performance.

A research has been done by Topal and Dogan (n.d) which is showing a positive relation between board size and firm relationship. Faisal (2005) stated that board size has a significantly positive effect on firm performance. As well as

the research done by Pfefer (1973) and Pearce and Zahra (1992). Another study carried out by Ibrahim and Samad, (2011) and Ahmad, Tariq, Hamad, and Samad, (2014) states that the board size significantly affects the company's firm performance.

2.4.2 Independent Board and Firm Performance

As there is a new regulation from Indonesia Stock Exchange which is stated that company that listed in IDX should be have 30% Board of Independent Commisionar from total of all the independent board. Khan and Kotishwar (2011), stated that an Independent Director is an independent who was choosen by the director of the company to share his idea or view on the company's performance regardless of internal interests. Independent board taking a big role in the company such as monitor the function of other commisionar in company and giving advice to the board of director about how to improve company and giving more point to the company. The existence of board independent in the company for achieve objectivity, independent and fairness, also make sure there is a balance in majority of shareholder. The measurement of the board of commissioners used in this study (Chaarani, 2014).

But from research that has done by Wehdawati et al (2015)., showing independent board giving negative response for firm perfomance in financial aspect. This could be the effect of adding more independent board only for fulfill the regulation that state by Pedoman Umum GCG Indonesia but in the other side the majority shareholder still taking a big role in the company and independent board could not do anything especially for decrease agency problem.

Sukmono (2015), mentioned that the existence of independent board giving a positive result for firm performance. And there is another similiar research that done by Saragih, Nugroho and Eko (2012). J. Brickley, J. Coles, R. Terry detect a positive relationship between outsider by reaction of the stock market. Another research that had been done by L.D Brown and M.L. Caylor found no relationship among board independent and Tobin's Q, but found a positive relationship between independent board and ROE, profit margin, divident yield, and stock repurchases. Another research done by Brown and Caylor (2004) and El Chaarani (2014) found a positive and strong relation between independent boards and performance company.

2.4.3 Outside Director and Firm Performance

According to Law No. 40 of 2007 concerning Limited Liability Companies, Directors are corporate organs authorized and fully responsible for company management for the advantage of the company, following the company's goals and objectives and represent the company both from outside and inside the court by the provisions of the articles of association. Whereas according to Zarkasyi (2008), the Board Directors is a group of individual chosen to act as representatives of shareholders to develop rules related to company management and make important company decisions.

The members of the board of directors is considered to hold an important role in improving the firm performance, especially in the company financial performance. The board of directors has an fatal role in supervise management activities evaluating the performance of the manager and rewarding the manager. Fama and Jensen stated that the Board Directors is part of the company that

performs tasks for Internal Control. And is one part that aims to oversee top management. And as the task of a board directors that oversees the activities of the company is believed to influence in increasing and decreasing the financial performance of the company. Outside Director which is not directly related to management activities of the company certainly has a greater role. Usually, outside directors are more thorough and better at controlling and supervising company management activities, because the main focus is not to disappoint stakeholders.

S. Rosenstein and J. Wyatt (1990) detect a significant outside director effect on performance firms. J. Brickley, J. Coles, R. Terry (1994) also found a positive relationship between the number of outside directors to firm performance. Conversely, Sari (2010) stated that there was no relationship found between outside directors and firm performance.

2.4.4 Audit Committe and Firm Performance

Audit commitee and firm performance believe to have important relation viwed from accountant because one of the dutied fro auditors is a responsibility the real value and position of company such as income, assests and equity depicts by the financial statement, stated by Indian Companies Act on 2013. Some consider that the audit committee that including into part of board of director have a task and responsible to arranging strategies for improving the financial performance in the company.In case audit team members could show the real condition of company financial condition in front of the board director, they suggest to prepare more effective strategies for increading the firm performance (Bhardjwaj & Rao, 2015).

Audit committee seen as an important factor of corporate governance. Cohen (2011) argued the independence of the audit committee was an important to show audit committee effectiveness. Governance codes that every company should apply to audit committe and ensurement for their independence. Firm which is having more independent members in their audit committee is expected have a lesser probability of becoming the victim of fraud (Beasley, 1996).

Some other research that has been done like Nuryanah and Islam (2011), Bouaziz and Triki (2012), Arslan et al (2014) mentioned that the independence audit committees improving audit report and also the firm performance. Al-Mamun (2014) viewed that a regular meeting of audit committee had positively effect towards firm performance. Utama and Leonardo (2006) found that audit committee has a significantly positive influence on firm performance. Another research done by Listyo and Khafid (2013) stated that no significantly influence found on firm performance.

2.4.5 Audit Committee Meeting and Firm Performance

Ayemere explained that audit committee meeting as the total number of meeting that held by the audit team in a year in a company. (Ayemere & Elijah, 2015). And audit committee meeting also explained as to examined how active the audit committee members to hold meeting annually. The more active the audit committee to hold meeting annualy it could be any improving in firm performance. If rarely hold a meeting may be less effective to monitor firm management activities. And mostly audit committee meeting are discussing about the error or any improvement needed for financial report. And mostly joined BoD meeting for giving suggestion about firm current situation or for any benefit for the future.

According to general rules published by BAPEPAM, which is mentioned that every audit committee in open company in Indonesia should hold meeting at least one time in three months. Even though the recommendation is to have at least 4 times meeting in a year but mostly board of dirctor would be call audit committee members to have a meeting.

2.5 Control Variable Effect on Dependent Variables

2.5.1 Effect of Leverage on Firm Performance

Leverage defined as the ratio of long term debt to total debt of firm. In some result has been done before like Zeitun and Tian (2007), Fauzi and Locke (2012), Lama (2013) found if high percentage of leverage giving a result of lower ROA. This is showing a high amount of debt negatively impact financial performance in the company but has positive impact market measure of the firm's performance.

Research did by Naimah and Hamidah (2017) showing that leverage and give negative influence to profitability. Ammari (2014) leverage as the control variable. And the result of the studies showing that it giving positive influence toward firm performance (Gurbuz & Aybars, 2010). Another studies by Wiranata that used leverage as control variable. And the result of the studies showing leverage positively impact for firm performance. (Wiranata & Nugrahanti, 2013)

2.5.2 Effect of Firm Size on Firm Performance

Firm size mentioned as a scale used to determine the proportions of a company (Sari, 2012). Measurement that can use to know the size of company is using the total asset of the company. Company size is measured using log total assets (Chaarani, 2014).

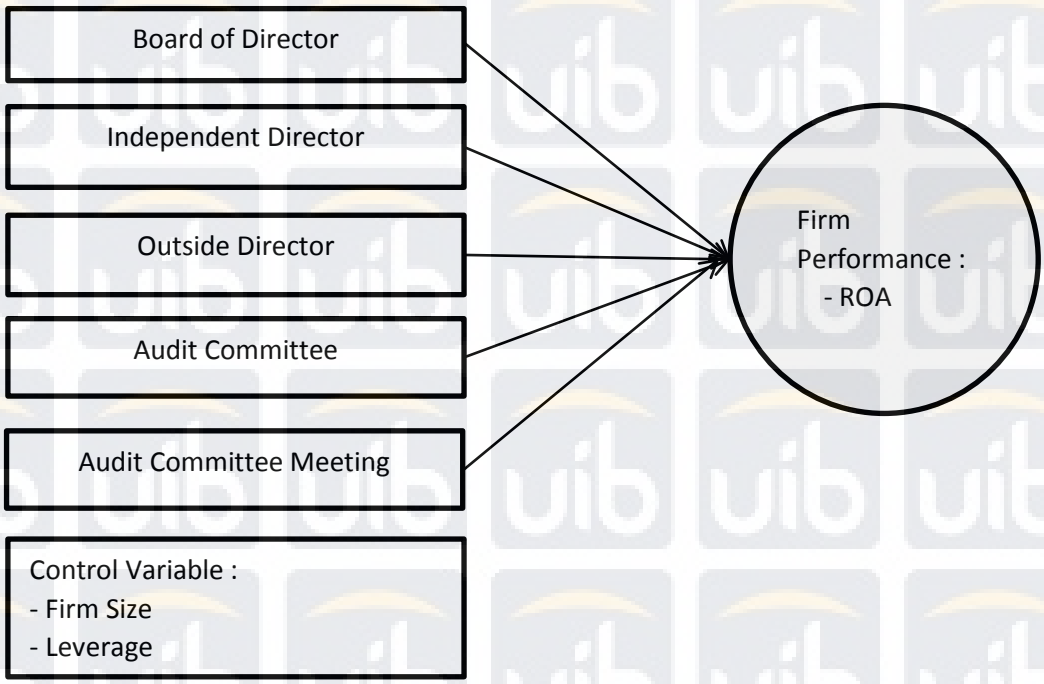
Large companies have better market access than smaller companies and have greater operational activities, so it is likely to generate greater profits that can improve company performance (Purnomosidi, Suhadak, Siregar, & Dzulkirom, 2014). Large Company has a greater growth compared to small companies, so the rate of return of large company shares is greater than the return of shares of small-scale companies. Greater profitability that found in large companies because if compared to smaller company, large company have more resources and they consequently have more flexibility for face the change on market (Salman & Yazdanfar, 2012). With this condition, got the point where company size has a positive relation wit firm performance.

This is supported by research conducted by Purnomosidi, Suhadak, Siregar, and Dzulkirom (2014), the size of the company has a positively impact on company performance. Other studies that show the same results as those conducted by Gill and Mathur (2011), Al-Amameh (2014) and Chaarani (2014) and Nur'ainy, Nurcahyo, A, and B (2013). Research did by Naimah and Hamidah (2017) showing that leverage firm size give negative influence to profitability. Another studies by Wiranata that adding firm size as control variable. It is resulting the studies showing firm size negatively impact for firm performance. (Wiranata & Nugrahanti, 2013).

2.6 Research Model

Picture 2.1

Influence of GCG towards company listed in Indonesia Stock Exchange



Dependent variable that will be used is ROA. Independent variable will be board director, independent director, outside director, audit committee, and frequency meeting of audit committee. And for control variable will be firm size and leverage.

2.7 Hypothesis Development

According to the description and framework explained above, the hypothesis development for this research is cocluded as follows:

H_1 Board size found to significantly positive impact on firm performance

H_2 Board independent found to siginificantly positive impact on firm performance

H_3 Outside director found to siginificantly negative impact on firm performance

H_4 Audit Committee found to significantly positive impact on firm performance

H_5 Audit Committee meeting found to significantly positive impact on firm performance