

# THE EFFECT OF GOOD CORPORATE GOVERNANCE ON FINANCIAL PERFORMANCE IN LQ45 COMPANIES LISTED IN INDONESIAN STOCK EXCHANGE

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## ABSTRACT

This study is conducted to examine the effect of good corporate governance on financial performance. The variables used in this study are the board of commissioners, the board of directors, institutional ownership and the audit committee as independent variables, while the dependent variable is financial performance proxies with ROA. This study uses 14 consistent samples of LQ45 companies that met the sample criteria during 2014 to 2018. The sampling technique in this research is purposive sampling in order to obtain 70 observations. Because the classical assumption test gets problems in the autocorrelation test, the data are transformed using the cochrane orcutt method, so that the total observations become 69 observations. The data analysis technique utilizes multiple linear regression analysis. The results of this study indicate that the board of commissioners has a positive and significant effect on financial performance, while the board of directors has a significant negative effect on financial performance, and institutional ownership has a significant positive effect on financial performance, while the audit committee has a significant negative effect on financial performance. Based on the determination testing of variable of the board of commissioners, board of directors, institutional ownership and audit committee in the regression model, this study is able to explain the dependent variable of financial performance by 32.9%, while 67.1% is explained by other variables not examined in this study.

**Keywords:** Good Corporate Governance, Financial Performance, Board of Commissioners, Board of Directors, Institutional Ownership and Audit Committee.

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## INTRODUCTION

A successful and surviving company cannot be separated from good governance. Good governance within the company will have an impact on good company performance. Companies must apply a good corporate governance to keep being able to compete and survive in a business competition at present and in the future. If the company's performance has increased, it can be seen from the incessant activities of the company in order to generate profits or profits as large as the amount (Pahlawan, et al, 2018).

Good corporate governance (GCG) is an internal control system that has the main objective of managing significant risks in order to achieve its business objectives through safeguarding company assets and increasing the value of shareholder investment in the long term (Effendi, 2016: 2). The concept of GCG has developed due to public demands for the realization of healthy, clean and responsible business activities (Pahlawan, et al, 2018). Many public companies has collapsed and has gone bankrupt because of the failure of strategies and undetected fraudulent practices of top management for a long time due to weak independent supervision by corporate boards (Manossoh, 2016: 1).

Pahlawan, et al. (2018) defines good corporate governance (GCG) as a design used to increase the performance of a company through supervision or monitoring of management performance and maintain management accountability to stakeholders based on regulatory concepts. The framework of good corporate governance is applied in order to implement company management as its rules to improve its company performance. In order to reach good corporate governance, companies must apply the principles consisting of the core of good corporate governance in managing the company.

The principles of good corporate governance are described by the NCGP (National Committee for Governance Policy) as follows: transparency, accountability, responsibility, independence, fairness and equality. To support and realize them, there are several supporting indicators for the good corporate governance mechanism, including the audit committee, managerial ownership, institutional ownership, the board of directors and the board of commissioners. A survey conducted by ACGA (Asian Corporate Governance Association) on business behavior in Asia shows that Indonesia is still in 12<sup>th</sup> rank in the good corporate governance. Table 1 shows the ranking of the implementation of good corporate governance (GCG) in Asia.

**Table 1**  
**Market Ranking GCG in Asia 2018**

Country	2018
Australia	1
Hong Kong	2
Singapore	3
Malaysia	4
Taiwan	5
Thailand	6
Japan	7
India	7
Korea	9
China	10
Philippines	11
Indonesia	12

Source: ACGA, 2018

The results of ACGA (2018) showed that Indonesian companies got the low scores in realizing the principles of GCG compared to other Asian countries. The weak implementation of GCG was due to a lack of awareness of a value and basic practices in running a business. In fact, the implementation of GCG should be able to improve their financial performance.

Financial performance can measure a company's operating success in a certain period. Good financial conditions are able to attract investors' attention. They will invest their capitals in companies that have good financial performance. Besides financial reports, they must also see the prowess of how the company can run its company well. They can clearly see the financial statements in the good corporate governance sheet. The better and more they understand and know the company's performance, the more sure they invest in the company (Lubis and Ovami, 2018).

Hanafi and Halim in Pakpahan, et al. (2017) explain that return on assets is a company's financial ratio related to profitability measuring the company's ability to generate benefits or profits at certain levels of income, assets and share capital. Return on assets can be used to assess whether the company is efficient in using company assets in operating activities to get profits. The higher the ROA, the more efficient the company uses assets to obtain the profits or net income (Pahlawan, et al, 2018).

The object of this research is the LQ45 Companies. The LQ45 Index is an index measuring the price performance of 45 stocks that have high liquidity and large market capitalization supported by good company fundamentals. Based on the description, the

researcher is interested in examining the Effect of Good Corporate Governance on Financial Performance at LQ45 Companies listed on the Indonesia Stock Exchange.

## **THEORETICAL BACKGROUND**

### **A. Agency Theory**

Agency theory provides an overview of the contractual relationship between agent and principal, where the agent is obliged to perform tasks for the principal's interests (Manossoh, 2016: 80). According to Jensen and Meckling in Eksandy (2018), agency theory views that company management, as an agent for shareholders, will act in full awareness of its own interests, not as a wise and fair party to shareholders.

One of the main agency relationships is between the management group and the company owners group. Managers are hired by company owners to manage its activities in creating agency relationships. The interests of owners and managers may be different, so it is easy to see that the manager's utility-maximizing behavior can run against with owner's interests. The owners have an interest in maximizing the return on investment and the securities' price. Meanwhile, managers have broader economic and psychological needs, including maximizing their total compensation fulfilled through work contracts. Because of this potential conflict, the owners are motivated to enter into contracts with them in a way that can minimize the conflict of interest between them (Manossoh, 2016: 78).

### **B. Financial Performance**

Financial performance is often used as the basis for evaluating company performance. It can be interpreted as the condition of the company in which certain measures are needed to analyze the financial performance of a company.

Pahlawan, et al, (2018) explain that the financial performance is the condition of a company, in which the financial condition of a company can be seen whether is good or bad to be a reference for work performance within a certain period of time. If it has increased, it can be seen from the incessant activities of the company in order to generate the maximum benefit or profit. It can measure the success of a company's operations in a certain period. Good financial conditions can attract the attention of investors. They are willing to invest their capitals in companies having good financial performance (Lubis and Ovami, 2018).

### C. Good Corporate Governance

Good corporate governance is a company internal control system that has the main objectives of managing significant risks in order to meet business objectives through safeguarding company assets and of increasing shareholder investment value in the long term (Effendi, 2016: 2). To support and realize them, there are several supporting indicators for the good corporate governance mechanism, including the followings:

#### 1. Board of Commissioners

Based on Constitution Number 40 of 2007 about Limited Liability Companies, the board of commissioners is a board whose task is to supervise and provide some advice to the director of a limited liability company. It is the center of the company's resilience and success, which is the core of corporate governance, assigned to ensure the implementation of corporate strategy, to supervise management in managing the company, and to oblige its accountability.

#### 2. Board of Directors

According to Constitution Number 40 of 2007 about Limited Liability Companies (in Effendi, 2016: 30), it is an organ that is authorized and fully responsible for the management of the company, for the benefit of the company and represents the company, both inside and outside the court as stated in the provisions of the articles of association. Meanwhile, according to Article 19 in the Regulation of State Minister for State-Owned Enterprises Number: PER-01/MBU/2011 dated 1 August 2011 about the Implementation of Good Corporate Governance, Effendi (2016: 29) states that the board of directors in running the company has the following duties and responsibilities:

- a. The Board of Directors is obliged, in good faith and full of responsibility, to carry out the management of the company while still paying attention to the balance of interests of all parties with an interest in the company's activities.
- b. It must comply with the applicable laws and regulations, the articles of association and resolutions of the GMS.
- c. It leads and manages the company solely for the interests and goals of the company and always tries to improve the efficiency and effectiveness of the company so that it will improve the company's performance.

- d. It always maintains and manages the company's assets in a trustworthy and transparent manner. Thus, directors can develop a structured and comprehensive internal control system and risk management one.
- e. It should avoid conditions of the company's duties and interests that conflict against with personal interests.

### 3. Institutional Ownership

Institutional ownership has an important role in monitoring management because it can encourage an increase of more optimal supervision (Candradewi and Sedana, 2016). Companies with large institutional ownership show their ability to monitor their management. The greater the institutional ownership is, the more efficient the company assets are utilized (Hendriani in Lubis and Ovami (2018).

### 4. Audit Committee

The audit committee can synergize with internal audit to further improve the company's internal control system. If there are allegations of irregularities or fraud in the company involving its directors, the commissioner can assign the audit committee to conduct a special audit (fraud audit) (Effendi, 2016: 58). According to Ministerial Decree Number 117 of 2002 (in Eksandy, 2018), the purpose of establishing an audit committee is to assist the commissioner or supervisory board in ensuring the effectiveness of the implementation of the external and internal auditors' duties.

## **D. Framewrok**

### 1. The Relationship between Board of Commissioners and Financial Performance

The role of the board of commissioners can be seen from the characteristics of the board, one of them is its membership composition. The variable relationship between the board of commissioners and financial performance is predicted to have a positive relationship. The large number of its members will be maximally able to supervise the company. It has a role to monitor the performance of directors and managers. It also becomes the advisory party in decision making of the board of directors and managers.

The effectiveness of its supervisory function is reflected in its composition, whether the appointment of board members comes from inside or outside the company (Lubis and Ovami, 2018). Putri and Muid's research result (2018) showed that the board of commissioners has a significant positive effect on financial performance. This is supported

by the research of Rahmawati et al. (2018) showing that partially the board of commissioners has a positive and significant effect. Based on the research of Putri and Muid (2018) and Rahmawati, et al (2017), the following hypothesis can be formulated:

H<sub>1</sub>: It is assumed that the board of commissioners has a positive and significant effect on financial performance.

## 2. The Relationship between Board of Directors and Financial Performance

The role of the board of directors is very important and quite decisive for the implementation of good corporate governance (GCG). It takes full commitment from the board of directors in order that the implementation of good corporate governance can run as expected. The members of the board of directors are obliged to implement the principles of professionalism, efficiency, transparency, independence, accountability, responsibility and fairness (Effendi, 2016: 29). Research by Pahlawan, et. al. (2018) indicated that the board of directors is fully responsible for all forms of operational and corporate management activities to carry out their interests and achieve the company goals. Its responsibility is also on the interests of the company with various external parties such as suppliers, consumers and legal parties. Research by Pahlawan, et al. (2018) concluded that the number of board has a positive and significant effect on company performance. This is strengthened by Eksandy research (2018) which showed that the board of directors has a positive effect on financial performance (ROA) in Islamic banking. This is supported by Masitoh and Hidayah's research (2018) which indicated that it has a significant positive effect on financial performance. Based on research by Pahlawan, et al. (2018), Eksandy (2018) and Masitoh and Hidayah (2018), the following hypothesis can be formulated:

H<sub>2</sub>: It is assumed that the board of directors has a positive and significant effect on financial performance.

## 3. The Relationship between Institutional Ownership and Financial Performance

Institutional ownership had an important role in minimizing agency conflicts that occur between shareholders and managers (Jensen and Meckling (1976) in Candrdewi and Sedana (2016)). It has an important role in monitoring management because it can encourage a more optimal increase of supervision. The results of research by Lubis and Ovami (2018) showed that institutional ownership had a positive and significant effect on company performance. This is also supported by Candrdewi and Sedana (2016). Based on

the research of Pahlawan, et al (2018) and Candrdewi and Sedana (2016), the following hypothesis can be formulated:

H<sub>3</sub>: It is assumed that institutional ownership has a positive and significant effect on financial performance.

#### 4. Relationship between Audit Committee and Financial Performance

The audit committee carries out independent oversight of the corporate governance process. An effective audit committee works as a means to increase the effectiveness, responsibility, openness and objectivity of the board of commissioners (Effendi, 2016: 56). Its variable is predicted to have a positive relationship with financial performance. Aulia et al. (2018) and Ekaningtias' research results (2017) showed that the Audit committee has a significant positive effect on Return on Assets (ROA). Based on the research of Aulia, et al, (2018) and Ekaningtias (2017), the following hypothesis can be formulated:

H<sub>4</sub>: It is assumed that the audit committee has a positive and significant effect on financial performance.

## **METHOD, DATA AND ANALYSIS**

### **A. Population and Sample**

Sugiyono (2017: 61) defines population as a generalization area consisting of objects or subjects that have certain quantities and characteristics set by the researcher and conclusions are then drawn. The population in this study is LQ45 companies listed on the Indonesia Stock Exchange. Based on the sample selection criteria obtained from the Indonesia stock exchange (IDX), the sample is 67 companies of LQ45 included in the LQ45 Index during 2014-2018.

### **B. Operational Definition of Variables**

#### 1. Dependent Variable

The dependent variable used in this research is financial performance as proxied by return on assets. According to Hanafi and Halim in Pakpahan, et al. (2017), return on assets is a company's financial ratio associated with profitability measuring the company's ability to generate benefits or profits at certain levels of income, assets and share capital. ROA can assess whether the company has been efficient in using its assets in operating



activities to provide profits. To measure return on assets, the following formula can be used (Pakpahan, et al, 2017):

$$ROA = \frac{\text{Net Profit}}{\text{Total Assets}} \times 100\%$$

## 2. Independent Variable

The independent variable in this study is good corporate governance as proxied by the board of commissioners, board of directors, institutional ownership and audit committee.

### a. Board of Commissioners

The board of commissioners is in charge of supervising the company (Effendi, 2016: 26). Meanwhile, Constitution Number 8 of 1995 states that the commissioner is the party responsible for signing any documents related to the delivery of information to the public in the context of submitting registration. The board of commissioners in this study can be measured by referring to Lubis and Ovami's research (2018) with the following formula:

$$\text{Board of Commissioners} = \text{The Number of Commissioners' Board}$$

### b. Board of Directors

The board of directors is responsible for managing the company. It is elected by shareholders at the General Meeting of Shareholders (GMS) that represents the interests of these shareholders (Effendi, 2016: 26). In this study, the board of directors is measured by the formula referring to the research of Pahlawan, et al. (2018) as follows:

$$\text{Board of Directors} = \text{The Number of the Board of Directors' Members}$$

### c. Institutional Ownership

Erawati and Wahyuni (2019) stated that the greater the institutional ownership, the greater the voice power and encouragement of the financial institution to oversee management, and it consequently can provide greater encouragement for management to optimize company performance. Institutional ownership in this study is measured by the formula referring to the research of Erawati and Wahyuni (2019) as follows:

$$\text{Institusional Ownership} = \frac{\text{institutional investor stocks}}{\text{outstandhing stocks}} \times 100\%$$

### d. Audit Committee

The Indonesian Audit Committee Association (IKAI) defines an audit committee as a committee established by the board of commissioners that works professionally and

independently to assist and strengthen the function of the board of commissioners (or the supervisory board) in carrying out the supervisory function of financial reporting, risk management, audit and implementation of GCG in the company. In this research, audit committee can be measured by the following formula referring to the research of Aulia, et al (2018):

$$\text{Audit Committee} = \text{The Number of Audit Committee}$$

### **C. Technique of Collecting Data**

The data collection technique used in this research is documentation. According to Sugiyono (2017: 239) documentary data is a type of data in the form of writings, pictures or monumental works of a person. In this study, the technique of collecting data is collecting the annual report data and company performance summaries published through the company's official website and [www.idx.co.id](http://www.idx.co.id) connected with the research object.

### **D. Multiple Linear Regression**

Multiple regression analysis is used by researchers because the researchers intend to predict how the state (fluctuation) of the dependent variable (criterion) is, and two or more independent variables as predictor factors are manipulated (increase and decrease in value). So a multiple regression analysis will be carried out if the number of independent variables is at least two (Sugiyono, 2017: 275). The model used in multiple regression to see the effect of the board of commissioners, board of directors, institutional ownership and audit committee on return on assets (ROA) in this study is:

$$Y = \alpha + \beta_1 DK + \beta_2 DD + \beta_3 KI + \beta_4 KA + e$$

## RESULTS AND DISCUSSION

### A. Multiple Regression Analysis

The results of hypotheses testing in this study are as the followings:

**Table 2**  
**Hypotheses Testing Results**

Model	Unstandardized		Standardized	T	Sig.
	Coefficients		Coefficients		
	B	Std. Error	Beta		
1 (Constant)	3,922	3,667		1,070	,289
LagX1	1,242	,487	,257	2,550	,013
LagX2	-,982	,356	-,288	-2,758	,008
LagX3	,220	,047	,473	4,691	,000
LagX4	-2,153	1,034	-,217	-2,082	,041

Source: Processed Data.

From the results of the multiple linear regression testing in Table 2, the formed equation model is:

$$\text{Lag Y} = 3,529 + 1,242 \text{ LagX1} - 0,982 \text{ LagX2} + 0,220 \text{ LagX3} - 2,153 \text{ LagX4} + e.$$

### B. Determination Testing

The testing of determination shows how much the existing independent variables can explain the dependent one. The regression estimation results on the determination testing showed an adjusted R2 value of 0.329. It means that the variables of the board of commissioners, board of directors, institutional ownership and audit committee in the regression model of this study are able to explain the dependent variable of financial performance by 32.9% while 67.1% are explained by other variables not examined in this study.

### C. Discussion

From the results of the data analysis, several points can be discussed as follows:

#### 1. The Effect of Board of Commissioners on Financial Performance

The first hypothesis states that the board of commissioners has a significant positive effect on financial performance. The results of this study indicate that the first hypothesis is accepted, in which the board of commissioners has a significant positive

effect on financial performance. This means that the large number of commissioners in the company will have an effect on improving financial performance. Conversely, the small number of commissioners will affect the decline of financial performance. The large number of the board of commissioners will make its supervision much better, and there will be more advices and inputs for the board of directors. As a result, the management performance will be better and have an impact on increasing the company's financial performance (Rahmawati, et al, 2017).

This result is in accordance with agency theory proving that the board of commissioners has a duty to supervise management in carrying out all activities with their best ability for the company's interests to increase its performance (Aprianingsih and Yushita, 2016). The results of this study are also in line with the research conducted by Putri and Muid (2018) and Rahmawati, et al (2017) which showed that the board of commissioners has a positive and significant effect on financial performance.

## 2. The Effect of the Board of Directors on Financial Performance

The second hypothesis states that the board of directors has a significant positive effect on financial performance. However, the research results indicate that this hypothesis is rejected, in which the board of directors has a significant negative effect on financial performance. It means that the large number of directors' board in the company will affect the decline of financial performance. On the contrary, its small number will have an effect on increasing its financial performance. It is because the large number of directors in the company will make the decision making process take longer, and make communication and coordination less optimal. Jensen and Meckling in Ruslin and Santoso (2018) also show that a small number of directors can improve communication, coordination and cohesiveness that lead to make monitoring more effective.

The results of this study are not in accordance with the agency theory in which a large number of directors' board will make financial performance better because the more members of the board of directors in the company, the clearer the division of duties of each member will certainly have a positive impact on stakeholders (Rahmawati, et al, 2018).

Pahlawan, et. al. (2018) explained that the board of directors is fully responsible for all forms of operational and corporate management activities to carry out interests for the achievement of company's goals. Its responsibility also belongs to the interests of the

company with various external parties such as suppliers, consumers and legal parties. The results of this study are in line with the research of Wilar et al. (2018) which shows that the board of directors has a negative and significant effect on financial performance.

### 3. The Effect of Institutional Ownership on Financial Performance

The third hypothesis shows that institutional ownership has a significant positive effect on financial performance. The results of this study prove that the hypothesis is accepted because the institutional ownership has a significant positive effect on financial performance. It means that the large number of institutional shares in the company has an effect on improving financial performance. In contrast, the small number of institutional shares in the company affects the decline of financial performance. This is suitable with the agency theory, that is, due to the successful implementation of the supervisory function by institutional parties through share ownership, the management performance will be increasingly monitored and able to minimize the fraud committed by management, and as a result, the company's financial performance can rise (Sejati, et al, 2018).

Companies with large institutional ownership indicate their ability to monitor their management. The greater the institutional ownership is, the more efficient the utilization of company assets (Hendriani in Lubis and Ovami (2018)). The results of this study are in line with the research of Lubis and Ovami (2018) and Candradewi and Sedana (2016) claiming that institutional ownership has a positive and significant effect on financial performance.

### 4. The Effect of the Audit Committee on Financial Performance

The fourth hypothesis shows that the audit committee has a significant positive effect on financial performance. The research results indicate that the hypothesis is rejected, in which the audit committee has a significant negative effect. In other words, the large number of audit committees in the company affects the decline of financial performance. Conversely, if the number of audit committees in the company is small, it will affect the increase of financial performance. The large number of audit committees has the potential to have conflicts of interest among the audit committee's members. The conflicts of interest between the members of the audit committee make the company's financial audit process inoptimal.

This study result is inconsistent with the agency theory in which the audit committee is formed as a special committee that is expected to optimize the supervisory

function. Its duties include supervising the financial reports, the external auditing and the internal control system. An effective audit committee works as a means to increase the effectiveness, responsibility, openness and objectivity of the board of commissioners (Effedi, 2016: 56). Nevertheless, the research results are in accordance with the research conducted by Meidona and Yanti (2018) stating that the audit committee has a negative and significant effect on financial performance.

## **CONCLUSIONS**

Based on the presentation of the research results about the effect of good corporate governance proxied by the board of commissioners, board of directors, institutional ownership and audit committee on financial performance at LQ45 companies listed on the Indonesian stock exchange, it can be concluded as follows:

1. The board of commissioners has a significant positive effect on the financial performance of the LQ45 companies.
2. The board of directors has a significant negative effect on the financial performance of the LQ45 companies.
3. The institutional ownership has a significant positive effect on financial performance in LQ45 companies.
4. The audit committee has a significant negative effect on the financial performance of the LQ45 companies.

Based on the limitations and results of this study, the researchers provide some suggestions for future researchers as follows:

1. It is suggested that the future researchers add independent variables or other variables such as managerial ownership and independent commissioners that can affect ROA.
2. It is suggested that they use all companies listed on the IDX.
3. Further research should increase the time period of the study.

## **IMPLICATIONS**

1. Theoretical Aspect

This research is expected to provide empirical evidence about the factors that affect financial performance so that it can give the readers deeper insight and knowledge about financial performance. For researchers who are interested in examining the same

study in the concept of implementing good corporate governance, it is hoped that this research can be used as a reference base for further research.

## 2. Practical Aspects

- a. The research results are expected to provide some solutions and suggestions related to problems and the influence of good corporate governance on company performance. The results can be used as a material for consideration to evaluate, improve and increase the future management performance that will attract potential investors to do business' investment in a company by the assumption that the better the company's performance, the more accurate the financial information contained in its financial statements. The company will be more open in giving the investors any information about its performance in order to increase their confidences toward it.
- b. For prospective investors, this research is expected to be used as a reference for them before investing through the application of the concept of good corporate governance in assessing the financial performance of a company.

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