CHAPTER II

THEORITICAL REVIEW

2.1 Previous Research

Several researches concerning this topic have been conducted. Some of them are listed as follows:

1) Bayoud, Kavanagh and Slaughter, 2012.

This study examines the relationship between corporate social responsibility disclosure (CSRD) and corporate performance, employee commitment and corporate reputation in companies through stakeholder's pressures.

The annual reports of the period of 2007 and 2009 and the questionnaire survey were used as the data samples of this study. The reports were collected through the company web sites and/ or by visiting company office and 110 annual reports of 40 firms were gathered. While data on employee commitment and corporate reputation were gathered by survey questionnaires. 149 questionnaires were collected from a total population of 135 organizations of various sectors.

Dependent variables measure in this study is represented by financial performance measures (return on equity, return on assets and revenues), employee commitment and corporate reputation and CSRD stands as independent variable. and all of the control variables including the Age of the firm, the Industry type, and the Size of the firm. By using multivariate regression, this study results that there is a positive relationship between level of CSR disclosure in the annual reports and corporate performance in terms of financial performance and corporate reputation, while there is not significant relationship between level of CSRD and employee commitment

This paper has similarities and differences with the research of the author. Both of them examine the association between corporate governance and corporate performance. However, while Bayoud, Kavanagh and Slaughter's employ data of firms from various sectors, the author of this paper, myself, uses banks as the sample of study to assay the association between GCG and firm performance

2) Uwuigbe and Fakile, 2012.

This study examines the relationship between corporate governance and financial performance of banks. The sample used in this study is a range of data from reports of 63 banks under review and also the Nigerian Stock Exchange fact book (2008), which contains information on board size and the performance proxies. Variables of this study consist of corporate governance, which is represented by board size, as independent variable and performance, which is measured by ROE, as dependent variable.

By using regression analysis, it resulted that banks with board size below 13 are more viable than those with board size above 13. The study further observed that banks with larger boards recorded profits lower than those with smaller boards. Thus, this study concludes that there is a significant negative relationship between board size and bank financial performance.

This paper has similarities and differences with the research of the author. Both of them examine the implication of GCG, in this paper represented by board size, towards the performance of companies. However, Uwuigbe and Fakile's paper employ the data of banks in Nigeria, while the author if this recent paper uses commercial banks in Indonesia as data samples.

3) Mandaci and Gumus, 2010.

This study examines the effects of corporate governance, represented by ownership concentration and managerial ownership, on the firms' performance. The samples used in this paper are non-financial firms listed on the Istanbul Stock Exchange (ISE) in the year 2005, in the context of an emerging market. The number of firms in their sample is 203. Mandaci and Gumus excluded banks and leasing, investment, insurance and holding companies since their financial tables are different from non-financial firms

Dependent variables measure in this study is represented by firms' performance measured by Return on Assets (ROA), to measure profitability, and Tobin's Q ratios, the value of the firm. This study employs two independent variables, the percentage of shares held by the largest three shareholders and the percentage of shares held by the managers.

By applying multiple regression analysis to measure the effects of ownership concentration and managerial ownership on firm performance, this study finds that ownership concentration has a significantly positive effect on both firm value and profitability, while managerial ownership has a significantly negative effect on firm value.

Table 1.1
Similarities and Differences with Previous Studies

Description	Bayoud, Kavanagh and Slaughter	Uwuigbe and Fakile	Mandaci and Gumus	Author
Independent Variable	Corporate Governance	Corporate Governance	Corporate Governance	Corporate Governance
Dependent Variable	Firm Performance	Firm Performance	Firm Performance	Firm Performance
Sample	135 Libyan organizations in different sectors	63 banks from The Nigerian Stock Exchange fact book (2008)	203 non-financial firms listed on the Istanbul Stock Exchange (ISE)	Indonesian Commercial Banks
Study Period	2007 and 2009	2008	2005	2009 - 2011
Analysis Technique	Regression	Regression	Regression	Regression
Type of Data	Secondary	Secondary	Secondary	Secondary
Result	Level of CSRD has a positive relationship with company performance	Ownership concentration has a significantly positive effect on both firm value and profitability, while managerial ownership has a significantly negative effect on firm value	There is a significant negative relationship between board size and bank financial performance	

2.2 Theoretical Basic

2.2.1 Corporate Governance

Many literatures agree to the point that the concept of corporate governance has no clear set of definition as to what it means; in another word it is indefinable. However, many authors explain the term as something that we essentially know the nature of, but not a single word can perfectly express the meaning. Some financial commentators, like the UK Cadbury Report (1992) and the South African King Report (1994), basically express the term as “the system by which companies are directed and controlled”. Nonetheless, that seems not successfully illustrate the meaning of the term ‘corporate governance’.

One approach concerning the term ‘corporate governance’ adopts a narrow view, where the term is restricted to the relationship between one company and its shareholders. This is the traditional finance paradigm, explained in ‘agency theory’ (Jensen and Meckling, 1976).

According to Bank Indonesia regulation no. 14/08/2006 dated October 5, 2006, there are five basic principles of Good Corporate Governance (GCG). First, Transparency, First, Transparency, which is openness in expressing material and relevant information as well as openness in the decision-making process. Second, Accountability, which is clarity of organ function and implementation of firm management in running the company effectively. Third, Responsibility, which is management of the Bank's compliance with the laws and regulations in force and the principles of sound management of the Bank. Fourth, Independency, which is the manner in where bank management works professionally, without any influence or pressure from any party. Fifth, fairness, that is justice and equality in fulfilling the rights of all stakeholders, which comes under agreements and laws, and regulations in force.

Governance, under this study, is represented with three aspects: managerial share ownership, board size, and CSR expenditures disclosure through corporate’s annual governance report and/ or GCG self-assessment report. Firstly, the managerial share ownership is often interpreted as the distribution of equity among stockholders. These structures play great role in corporate governance as they regulate the incentives of managers and therewith the economic efficiency of the corporations they manage (Jensen and Meckling, 1976). Secondly, board size is regarding to the number of Board of commissioners (BOC) member. BOC is a group of individuals that are elected to make decisions on shareholders' behalf (Investopedia, 2013). Lastly, CSR expenditures disclosure is a breakdown report of CSR expenditure within the corporate governance annual report, which the company has made for certain period of time.

2.2.2 Agency Theory

Agency theory is used to be traced to the pioneering work of Adolf Berle and Gardiner Means (1932/1991) which was further studied by Jensen and Meckling. Agency theory explains that one personnel would put his or her best interest at the top of the list (Jensen and Meckling, 1976). This list of priorities determines the performance of one personnel within the company. This theory is a set of ideas on organizational control based on the belief that the separation of the ownership from management creates the potential for the wishes of owners to be ignored (John A. Pearce II & Richard B. Robinson,Jr, 2007). The existence of this separation can be effectively managed as long as both parties, the owner (principal) and the managers (agents), can understand one and another interest.

However, problem may occur within this relationship. Fama and Jensen (1983) in Marion Hutchinson & Ferdinand A. Gul (2003) stated that without good governance controls, managers' interests are more likely to deviate from the interests of the shareholders. When the governance control does not work properly, managers may want to take advantage of this situation by acting in ways that increase their own welfare at the expense of the gain of corporate stockholders. Therefore in order to achieve the goals of shareholders without neglecting the importance of managers, the practice of good corporate governance is needed. (Pearce II & Robinson,Jr, 2007).

2.2.3 Bank Performance

When we attempt to evaluate a bank performance, we look, in fact, for manners of measuring the economic and financial consequences of the decisions made by the company management, applied into operating, financing, and investment activities. An important problem that must be solved by the financial analysis is related to the assessment of the bank's efficiency in using its available resources, and of the extent to which the company profitability met the shareholders' expectations and of the prudence used for making financing decisions. There are several indicators to assess a company performance. Several measuring instruments are listed as follows:

1. **ROA**

   The Return on Assets (ROA) percentage shows how profitable company's assets are in generating revenue. (Crosson et all, 2008) ROA can be computed as:

   $$ROA = \frac{ReturnBeforeTax}{AverageTotalAssets} \text{………………………..……………} (1)$$

2. Return on equity (ROE)

ROE measures the rate of return on the ownership interest (shareholders' equity) of the common stock owners. It measures a firm's efficiency at generating profits from every unit of shareholders' equity (also known as net assets or assets minus liabilities). ROE shows how well a company uses investment funds to generate earnings growth. ROE can be calculated as:

$$ROE = \frac{ReturnAfterTax}{AverageEquity} \quad (2)$$

3. Net Interest Margin (NIM)

Net Interest Margin (NIM) is a performance metric that examines how successful a firm's investment decisions are compared to its debt situations. A negative value denotes that the firm did not make an optimal decision, because interest expenses were greater than the amount of returns generated by investments. NIM can be computed as follow:

$$NIM = \frac{NetInterestIncome}{AverageEarningAssets} \quad (3)$$

4. **Operating Efficiency Ratio (OER)**

OER is a ratio to measure the operating efficiency for banks. This ratio divides the operating expense of the bank by its net revenues. OER is formulated as below:

$$OER = \frac{Profit}{WeightedAverageCommonShares} \qquad (4)$$

2.2.4 Corporate Social Responsibility

On a wide range of issues corporations are encouraged to behave socially responsibly (Welford and Frost, 2006; Engle, 2006). However, in both the corporate and the academic world there is uncertainty as to how CSR should be defined. Some go as far as saying ‘We have looked for a definition and basically there isn’t one’ (Jackson and Hawker, 2001).

While definitions of CSR vary, the term generally refers to actions taken by firms with respect to their employees, communities, and the environment that go beyond what is legally required of a firm (McWilliams in Amir Barnea and Amir Rubin, 2010).

The purpose of corporate social responsibility (CSR) is to make corporate business activity and corporate culture sustainable in three aspects (Uddin, Hassan and Tarique, 2008). Those three aspects are:

1. Economic Aspects of CSR

This aspect should take into consideration direct and indirect economic impacts of the organization's operations toward the surrounding community and on the company's stakeholders. This aspect covers 3 points:

a) The Multiplier Effect

b) Contribution through taxes

c) Avoiding Actions that Damage Trust

2. Social Aspects of CSR

   This aspect refers to the management's obligation to make choices and take actions that will contribute to the well fare and interests of society as well as those of the organization. The following aspects have been found to be key the social aspects of CSR for an organization

   a) Responsibility towards Customers

   b) Responsibility towards Employees

   c) Responsibility towards the Community

3. Environmental and Ecological Aspects of CSR

   Environmental concern and sustainable development is a key pillar of the corporate social responsibility. It covers two aspects:

   a) Environmental Impact

   b) The Win-Win of Environmental Responsibility

2.2.5 Corporate Governance and Bank Performance

Corporate governance through its three component aspects in this study, managerial share ownership, size of BOC, and CSR expenditures disclosure, is examined regarding to their relationship toward bank performance.

1. **Managerial Share Ownership and Bank Performance**

   Stock distribution depicts the distribution of stocks among stakeholders, in which will influence corporate actions that are dependent on shareholders voting (Hutchinson and Gul 2003). By having bigger number of managerial share ownership, the agency problem will be less complicated (Jensen and Meckling, 1976). According to them, managerial ownership may reduce the agency cost, a problem between owner and its agent. Management share-ownership will ensure managers to undertake strategies that will increase firm performance (Hutchinson and Gul 2003). However, Mandaci and Gumus (2010) found otherwise. They stated that having too much share on managers' hand could lead the managers to over worried on their interest and decrease firm performance.

2. **Size of BOC and Performance**

   Some researchers like Lipton & Lorsch (1992) and Jensen (1993) found that size of board does matter to the performance of its company. They (Lipton & Lorsch, 1992) stated that smaller size of board works more effectively than larger ones due to co-ordination problems in larger boards. They suggested limiting the boards' member to ten people, with a preferred size of eight or nine. Jensen (1993) did a research under the same theme and resulted that boards with more than seven or eight people are less likely function effectively and are not easy for the CEO to control. There is a significant negative relationship between board size and bank financial performance (Uwuigbe and Fakile, 2012).

3. CSR Disclosure and Performance

CSR disclosure comes as a means of understanding and tracking CSR impacts, through creating good dialogue with stakeholders of a company and an effective CSR disclosure is intended to improve stakeholder-related performance (Bayoud, Kavanagh, and Slaughter, 2012). Their study brought findings that there is a positive relationship between level of CSR disclosure in the annual reports and corporate performance, in terms of financial performance and corporate reputation.

2.2.6 Board System

Every country might apply different system of corporate governance, especially regarding the board system. Some countries apply a one-tier board system (like the U.S.) and some others apply a two-tier board system (like Germany). Each of these systems has different way in supervising the company. A one-tier board applies one board of directors, in which it includes all the directors (both executive directors and non-executive directors) in one board. While a two-tier board system separates the executive directors and the non-executive directors (Wikipedia, 2013). Indonesia applies the two-tier system.

2.3 Framework

Based on the above literature review, it can be concluded that there is a relationship between corporate governance and firm/bank performance. Two aspects representing corporate governance in this study, in accordance to previous researches and theory, and CSR disclosure are expected to have effects on firm/bank performance. This relationship is illustrated in the following framework:

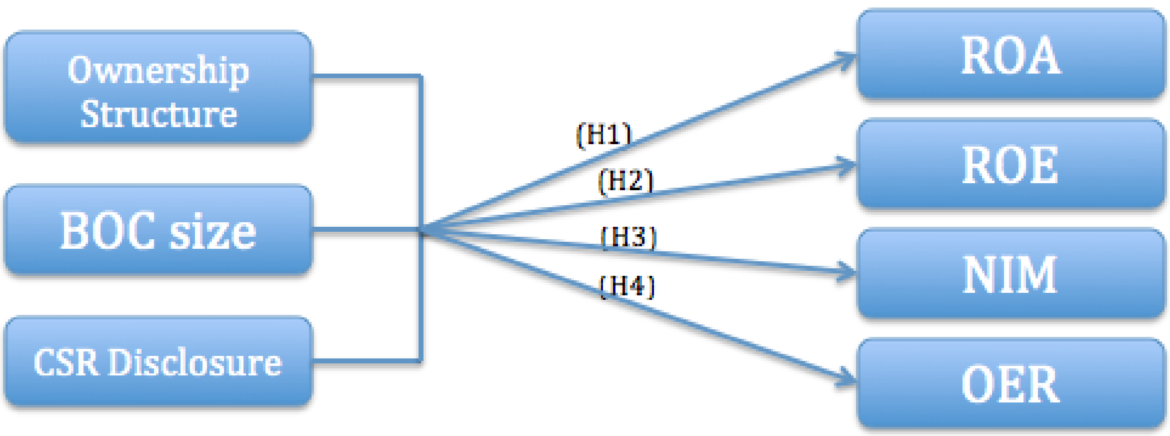

Figure 2.1
Framework

2.4 Research Hypothesis

Based on the above, the researcher advance the following hypothesis:

H1: There is a significant partial effect of managerial share ownership, size of BOC, and CSR disclosure toward the bank's ROA

H2: There is a significant partial effect of managerial share ownership, size of BOC, and CSR disclosure toward the bank's ROE

H3: There is a significant partial effect of managerial share ownership, size of BOC, and CSR disclosure toward the bank's NIM

H4: There is a significant partial effect of managerial share ownership, size of BOC, and CSR disclosure toward the bank's OER