CHAPTER I

INTRODUCTION

1.1 Background of Study

Good corporate governance is one of the important factors for the firm's life because it can affect the decision-making process, the balance of the framework, and understand the firm's management. Additionally, by good corporate governance's (GCG) implementation, companies can carry out their management reliably, mitigate risks, maintain product quality standards, improve access to capital, and make the company more efficient which reflects the economy of a country's condition (Muliaman D Hadad, 2014). However, in recent years the failure of GCG implementation triggers the financial crisis in the last decades, which has further worsened Indonesia's economic conditions (Muliaman D Hadad, 2014).

Financial crisis in 1997 was the worst banking industry in history. Therefore it became a lesson for banking industry how important prudential management is. As a part of the prudence principle, bank has awareness to develop sustainability business through the implementation of GCG. According to KNKG (2006: 1) the banking crisis in Indonesia was not only caused by an economic crisis, but also caused by improper the implementation of good corporate governance and the underlying ethics. Therefore, the efforts to restore trust in the banking world Indonesia through restructuring and recapitalization can only have long-term and fundamental impacts if accompanied by three important actions others, which are in line to the principle of prudence, implementation of good corporate governance, and an effective oversight of the authority bank supervisor. The banking industry is an industry which requires the trust of the public and investors. Therefore, the implementation of regulations and principles of good corporate governance in banking industry is the main requirements to protect the interest of all stakeholders.

The results of the assessment for the overall implementation of Good Corporate Governance (GCG) using ASEAN CG Scorecard (International Institute for Communication and Development 2013; 2014) put Indonesia in fifth place in ASEAN with an index value of 43.29 in 2012 and 54.55 in 2013. This shows that the implementation of corporate governance based on the principles of corporate governance has increased but still have lack of the regulations and compliance with existing regulations (Asian Development Bank 2014). The results of the assessment also showed that there are many public companies in Indonesia had received a negative assessment of the corporate governance index regarding transparency and the responsibility of the board of commissioners. Nearly 20% of companies assessed by the IICD did not disclose when determine independent commissioners and many of them have served more than 9 years so the independence of commissioners are being doubted. Furthermore, the lack of process of determining the commissioner also lead to a bad start in the implementation of GCG remaining the roles and responsibilities of the board of commissioners are the important part to encourage the quality of corporate governance implementation. The implementation of principles of corporate governance is a crucial element in banking industry and it is one of the bank needs to considering the challenges and risks that is keep getting complex. Implementation of governance as a system that is done through internal process that involves all levels and positions in the organization especially for the board of commissioners and board of directors who has a very crucial role in the implementation of governance in the business environment of banking.

There are many factors that could influence the implementation of corporate governance and one of them is family ownership. Muliaman Hadad, the former governor deputy Bank Indonesia stated that 70% of Indonesian bank is owned by family. He also stated family-owned bank usually put their family member in directors and commissioner. Based on statistics data, most of collapse bank case was not caused by competition but fraud. It may cause depth intervention so that the governance cannot control well (Detik Finance, 2011). Families tends to dominate most of the shares in the company so that they are could being majority shareholders whose the votes will be most influential in making decisions which is lead a conflict of interest between minority and majority shareholders in determine the direction of the company. Family members from founder families who place top leaders such as commissioners and director would have enormous control rights so that they are not easily disciplined if they make mistakes or deviations which contrast to professional board without significant share ownership.

This could be happened because board members from external firm have financial and accounting expertise and can be more objective and professional in carrying out their duties because they have no interest in any parties. This is also in line with OECD (2004) which stated that the key functions of the board of commissioners are to believe in the integrity of accounting and corporate financial reporting systems.

One of family ownership characteristic is an informal form in decision-making process. This causes governance practices has tendency to do not work well and the company policies taken are more likely to be more beneficial for company's controlling interests which is family (Hadjiprayitno, 2013). The large proportion of family ownership encourages the determination of management who has a close relationship with the family by the controlling shareholders through a collection mechanism that is dominated by the votes of the controlling shareholders. The tendency of family elements to maintain the status quo could be a cause of poor implementation of corporate governance so that the profits as majority shareholders can be maintained, and it is not only through management but also by family-affiliated commissioners (Haque, Arun, & Kirkpatrick, 2011).

Moreover, the other cause of the improper implementation of good corporate governance is the presence of political elements. A company is said to be politically connected if at least one of the largest shareholders of the company (anyone either directly or indirectly controls 10% of the votes) or board of directors (CEO) is a member of parliament, a minister, or a head of state, or is someone who has a close relationship with top politicians (Faccio, 2002). Faccio

(2007) also stated political connected firm have a higher level of leverage, costs associated with less financial distress, and low accounting reporting quality.

In Indonesia, for example, a condition for IMF lending in the aftermath of the Asian financial crisis was that Suharto would sign an agreement that made companies controlled by his family give up lucrative government concessions, monopolies, licenses, government contracts, and tax breaks that protected them from competition in their domestic market which is such a huge benefit. In fact, when the Indonesian Bank Restructuring Agency published the names of Indonesia's main corporate borrowers, Suharto's children figured on the top of the list: "Second on the list, with 3.5 trillion rupiah in loans, is Timor Putra Nasional, the auto firm controlled by Tommy Suharto. Number five, with 2.9 trillion rupiah in debt, is a petrochemical company owned by the timber tycoon Prajogo Pangestu and Suharto's second son, Bambang Trihatmodjo (Faccio, 2007). The influence of the political connected firm is not only on its financial performance but also on the practice of implementation corporate governance. According to Micco, Panizza, and Yanez (2007) there is a possibility of financial reporting of companies that have political connections adjusting their financial statements to the interests of controlling shareholders so as to sacrifice the interests of other shareholders. According to Bebchuck and Neeman (2005), politicians means the government has a stake in determining the level of investment protection through regulations, and policies so that interested parties such as company insiders, institutional shareholders, and employers will try to lobby politicians to obtain appropriate level of protection.

Thus the issue of the political connected company with corporate governance is also interesting to be study further. Remaining the importance of the implementation of good corporate governance for the life of the bank, therefore the author is interested in examining the influence of family ownership, family aligned board, and political connections on the implementation of corporate governance.

1.2 Research Problem

Based on the background, research problem of this study are**:**

1. Does family ownership have a significant negative effect on the implementation of corporate governance?
2. Does the family aligned board have a significant negative influence on the implementation of corporate governance?
3. Does the political connection have a significant effect toward the implementation of corporate governance?
4. Do family ownership, family aligned board and political connection simultaneously effected the implementation of good corporate governance?

1.3 Research Objective

The purpose of this study is to:

1. Examine the effect of family ownership on the implementation of good corporate governance.
2. Examine the effect of family aligned boards on the implementation of good corporate governance.

3. Examine the effect of political connections on the implementation of good corporate governance.
4. Examine whether family ownership, family aligned board and political connection simultaneously effected the implementation of good corporate governance.

1.4 Research Benefit

The results of this study are expected to provide several benefits for several parties, especially:

1. Bank

The results of this study are expected to add to the bank's insight about the importance of implementing good corporate governance. By the implementation of good corporate governance, it is expected could have a positive influence on the quality of financial reports which is reflected in the decreasing level of falsification carried out by management, increasing professionalism practice, also keep shareholder's welfare without neglecting the interests of stakeholders.

2. Shareholder

Information about the implementation of GCG in banks that have political connections and the influenced family aligned board is expected to be used by investors to assess the risks, so the decisions that made will include all possible risks.

3. Readers and Future Research

The results of the study can provide additional information and knowledge about GCG practices in politically connected bank and influence by family aligned boards. So that it can be useful for further researchers as reference material and research comparison.

1.5 Systematic of Thesis Writing

Thesis was prepared with the systematic of writing that consist five chapters with the following detail:

CHAPTER I : INTRODUCTION

This chapter describes the background issue that underlying this research, the purpose, the benefits of the research, and the systematic of proposal writing.

CHAPTER II : LITERATURE REVIEW

This chapter describes about previous research, basic theory, research framework, and hypothesis.

CHAPTER III : RESEARCH METHOD

This chapter describes in details the research method of study design, limitation of the study, identifications variable, operational definitions, and measurement variables, population, sample and sampling techniques, data and data collection method and data analysis technique.

CHAPTER IV : DESCRIPTION OF RESEARCH SUBJECT AND DATA ANALYSIS

This chapter describes the result of the research and discusses the result by correlating with previous study and related theory.

CHAPTER V : CONCLUSION

This chapter concludes the result of study, inform the study limitation, and give a recommendation based on the result.