Corporate governance award and performance of Indonesian LQ45 firms

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Abstract. This research aims to examine the impact of CGPI award on firm’s operational performance. Contrary to our expectation, using a sample of 45 companies listed in LQ45 index during 3-year observation period, it is found that corporate governance award has a significant negative relationship with companies’ performance. We use CGPI awardee/ non-awardee to represent corporate governance award and ROA as a proxy of firm performance. Control variables included in this research consist of independent commissioners’ independency, board of director size and firm size. The unexpected negative relationship might indicate that the additional costs that must be borne by companies to implement good corporate governance practices, eventually become disadvantageous to their operational performance. The similar conclusion is found for the longer-term performance. Furthermore, we also find that the average ROA of CGPI awardees is much lower than the non-awardees, arguably due to the costly efforts put forward by the awardees to carry out and report on their corporate governance practices. The result of this research confirms the stewardship theory, in which the awardees put management as a steward and govern the firms to grow in size, however it comes with a certain cost that reduces their profitability.

Keywords: corporate governance

1. Introduction

As corporations have expanded and become more complex, the attention to corporate governance (CG) implementation has become more important, corporations need to set the framework in order to ensure that their activity is in accordance with the governance. Corporate Governance includes the following aspects of corporations: ownership and control, goals, rights, responsibilities, and value distribution [1]. These aspects are essential for those internal and external parties of the corporations, which in general referred to as stakeholders. Most companies would strive to have a high level of CG as it can affect corporate financial performance, as indicated by previous research results [2], [3], [4], [5], [6], [7], [8], [9], [10], [11], [12], [13], [14]. Several measures were used to measure corporate financial performance, such as return on asset (ROA), return on equity (ROE), earnings per share, and profit margin. Moreover, CG can also affect firm value [3], [15], [16], [17], [18] and lower the cost of debt [19], [20].

The emergence of CG in Indonesia is triggered by the financial crisis that occurred in 1998 as the government expected an improvement of economy and companies’ value in Indonesia. The Indonesian government then established Komite Nasional Kebijakan Governance (KNKG) in 1999 to encourage...
and improve good governance implementation both in public and private sectors. The adoption of good corporate governance (GCG) for companies in Indonesia, similar to other countries, is very important to support the stability and sustainable economic growth. Halimatusadiah, Sofianty and Ermaya [21] found that GCG implementation affected corporate profitability, which was measured by ROA. In line with this, the mechanism to improve and maximize corporate financial performance can be achieved by implementing good governance in the organization [22].

The improvement of CG implementation in Indonesia has led to the emergence of a program called Corporate Governance Perception Index (CGPI) by The Indonesia Institute for Corporate Governance (IICG). CGPI is a research program that assesses and ranks GCG implementation of Indonesian companies by encouraging companies to enhance the quality of their CG practices through evaluation process as well as benchmarking. CGPI plays a crucial role in bringing companies’ reputation in the society as well as in maintaining investors’ confidence. A higher CGPI rating means better transparency, responsibility, accountability, fairness, and independency. Since investors are likely to consider this rating when making their investment decisions, it is expected that the higher the rating is, the more positive impact it will bring to the company’s performance. However, a previous study shows that there was no direct response by the market in relation to the rating of Indonesian companies’ CG implementation and it was also unable to increase the short-term growth of the companies [23]. They observed the CGPI rating and market performance of the companies in the same year, which could explain the non-direct response of the market. There have not been many prior studies that use CG award as an indicator of CG in addition to other more common CG measures, therefore this research contributes the the CG area by incorporating the holistic measurement of CG award, represented by CGPI, as the main focus.

Using a sample of 45 companies listed in LQ45 index during 2015-2017, the authors found that CGPI negatively affects companies’ performance, which was measured by ROA. Other CG measures used in this research, i.e. independent commissioners and board of director size, positively affect ROA, although only board or director size was found to be significant. The implications of this unexpected relationship sign between CGPI and companies’ performance may indicate that GCG implementation cost companies their operational performance. The remainder of this paper is structured as follows: section 2 discusses the theoretical framework underpinning CG, section 3 provides explanations regarding the research method, section 4 presents research result and discussion, while section 5 concludes this research.

2. Theoretical framework
This part discusses stewardship theory as one of the relevant theories underlying CG, as well as hypothesis development of this research.

2.1. Stewardship theory
Stewardship theory is one of the theories that could explain CG, it is of particular relevance in this research [24]. Stewardship theory assumes that managers are loyal to the company and interested in achieving high performance. In particular, managers are seen as those who are motivated to achieve satisfaction in their work by delivering organizational success in their work, as well as to carry out their responsibility and authority to gain recognition from their leaders and other parties for their success. Stewardship theory emphasized more on top management’s role as stewards with the integrated objectives as part of the organization; it is the underlined concern of stewardship theory [25].

Moreover, managers operate the firm to achieve satisfactory financial performance, hence maximizing the profit of shareholders and maintaining their reputation [26]. It is assumed that the shareholders’ perception on managers’ performance is dependent on firm performance. Therefore, managers can be regarded as effective stewards and preserve their career in the firm [24]. Moreover, to reduce agency costs and to improve on the stewardship role, this theory also suggests merging the CEO and chairman role, to better safeguard shareholders’ interest in the organization.
2.2. Hypothesis development

In Indonesia, most companies have not fully implemented GCG due to the General Guidelines of GCG in Indonesia that is voluntary, and no legal sanctions if the company does not implement the guidelines. For public companies however, the Financial Services Authority of Indonesia (OJK) has issued guidelines on corporate governance implementation through POJK 21/POJK.04/2015 [27] that require public companies to disclose their corporate governance practices in annual reports, effective from 31 December 2016. If there are any violations to the guidelines, OJK will impose administrative sanctions in forms of written warning and fines. As part of the guidelines, OJK has also issued a circular letter 32/SEOJK.04/2015 [28] that includes 5 aspects of GCG practices: relationship between public companies and shareholders in guaranteeing the rights of shareholders, function and role of board of commissioners, function and role of board of directors, stakeholders’ participation, and information openness. These 5 aspects are then broken down into 8 principles and 25 recommendations of GCG practices.

The government should create a supporting regulatory environment for GCG enforcement and request public companies’ participation in the CGPI program. In that way, this strategy aims to improve companies’ commitments on GCG implementation. It is also expected that companies can implement GCG not only for the sake of ticking the box of regulations, but further to help them improving the companies’ performance and integrate GCG implementation into the corporate culture [23]. After all, good governance is one of the pillars of corporate sustainability, besides environmental, social, and economic pillars [29]. In order to assess GCG implementation in a company, IICG has a program called CGPI which has been operating since 2001 until now. CGPI is a research program that assesses and ranks GCG implementation of Indonesian companies by encouraging companies to enhance the quality of their CG practices through evaluation process as well as benchmarking. CGPI is attended by public listed companies (issuers), state-owned enterprises, banks, and other private corporates. There are many CG-related aspects that will be evaluated in the CGPI assessment, which in general consist of the following: the company’s commitment, transparency, accountability, responsibility, independency, fairness, leadership, capability, strategy, risks, ethics, culture and sustainability. This indicates significant efforts that must be put by companies to implement GCG practices.

CGPI can be regarded as one of CG indicators in Indonesia. Companies that are listed in the CGPI ranking score have been proven to have implemented a GCG which directly increase their value of the market shares. CG award also has a huge impact for the company, not only to get the good reputation in society, but also to increase and maintain investor’s confidence to invest in their company. Specifically, there are several benefits of CGPI. Firstly, to arrange a company that is not yet in line and has not supported the realization of GCG. Secondly, to increase awareness and share the commitment of companies and stakeholders on the implementation of GCG. Thirdly, to specify the mapping of strategic problems in GCG practices. Lastly, to act as alternative improvements to quality indicators or quality standards. Using a sample of companies that were listed in the Jakarta Stock Exchange in 2001 and 2002 and were included in the ranking list of GCG implementation conducted by the IICG, Darmawati et al. discovered no significant relationship between CG index and Tobin’s Q, but a significant positive relationship was observed between CG index and return on equity [30].

In non-Indonesian context, Epps and Cereola’s study on the relations of CG rating on the company's performance in 2002-2004 compared the Institutional Shareholders Services (ISS) CG quotient (CGQ) rating with two measurements of the company's operational performance, namely ROA and ROE [31]. The result showed that no statistical evidence was found if the ISS CG rating affects company performance. Next, another research shows that GCG is highly correlated with asymmetric information and contracting imperfections that are represented by the composition of assets, growth opportunities, and company size [32]. Companies with high level of GCG are commonly found in countries with weak legal systems. GCG is positively correlated with the company's operational performance as measured by ROA and market valuation as measured using Tobin’s Q.
CGPI is expected to play an essential role. A higher CGPI rating presumably implies that the company is better managed in terms of CG principles of transparency, independency, responsibility, accountability, and fairness. Therefore, by achieving the award and acquire a predicate of a highly trusted company, it is assumed that the company will get a higher competitive edge as it is expected to increase the firm performance, contemplating that investors and creditors will take into account CGPI rating into their investment decision-making process. Thus, from the theories and explanation above, the authors develop the following hypothesis: GCG implementation based on CG award positively affects the company’s financial performance.

This study also considers two other CG measures, board of director size and independent commissioner, as control variables that could affect firm performance. The governance of both board of commissioner and director is an essential part of a company’s GCG practice, hence OJK includes this in its GCG guidelines as two separate aspects [27]. Proper governance on these two aspects are imperative for companies to satisfy the widely accepted CG principles of transparency, fairness, accountability, and responsibility. Prior studies have found that board of commissioners’ independency has a positive effect on firm performance and firm value measured by various proxies such as return on assets and Tobin’s Q [9], [10], [17]. It has also been argued that there the board of director’s governance influences firm performance. Kakabadse et al. [33] identified 4 board attributes that might affect the performance of companies: board composition, characteristics, structure, and process. An example of board composition is board size, which has shown to have significant effect on firm performance in previous research, with mixed results regarding the direction [10], [11], [12], [13], [34]. To represent firm performance, this study uses return on assets (ROA), as also utilized by several prior literatures [6], [7], [9], [10], [11], [12], [13], [34]. The use of ROA is also relevant in the context of stewardship theory, where managers are entrusted with the resources (assets) to be well-managed and generate return to the shareholders.

3. Research method
This study uses firms that were listed in LQ45 IDX in 2017. All samples should have full annual reports for year 2015 to 2017. A final sample of this study is 135 firm year observations. The dependent variable is company operational performance, as measured by ROA, and the main independent variable is a dummy variable for CGPI awardee. It takes a value of 1 if a firm was the CGPI awardee in a certain year t, and 0, otherwise. Although this study regards the CGPI represents the holistic measurement of the CG of a firm, the direct effect of two other corporate governance aspects, Board size and Independent commissioner is seen as important variables to control the CGPI effect. The choice of other CG aspects based on findings from prior studies that show both aspects are value relevant [3], [6], [8]. This study would like also to test its relevance on the operational performance. The other common control variable is firm size, measured by normal log of total assets of the firms. As explained earlier on in the hypothesis development, each independent variable (CGPI, BSize, INEC, in the research model are regarded as the cause of the dependent variables (ROA). Therefore, to test the hypothesis, this study applies OLS regression with the following equation,

$$ROA_{it} = \beta_0 + \beta_1 CGPI_{it} + \beta_2 BSize_{it} + \beta_3 INEC_{it} + \beta_4 FSize_{it} + \epsilon_{it}$$ (1)

Where $ROA_{it}$ is return on assets of firm $i$ in year $t$, $CGPI_{it}$ is a dummy variable for CGPI awardee in year $t$, $BSize_{it}$ is the board size of firm $i$ in year $t$, $INEC_{it}$ is percentage of independent commissioner in the board of commissioners of firm $i$ in year $t$, $FSize_{it}$ is normal log of total assets of firm $i$ in year $t$. Although this study employs a pooled data set, the OLS regression is deemed as an appropriate statistical analysis due to the occurrence of CGPI from time to time is quite random. Moreover, the hypothesis testing of each coefficient regression uses the white $t$-test to control for heteroscedasticity problem.
4. Results and discussion
The descriptive data analysis is performed to show the distribution of the data. We find some outliers in variable ROA, therefore we treat the outliers using winsorizing method for 1% top and bottom. The final descriptive statistics of the data is presented in Table 1. The dependent variable, ROA, has an average of 7.8411%, while most of the observations have ROA lower than 5.5%. Meanwhile, most the sample consists of non-CGPI awardee, 135 observations, there are only 29 CGPI awardee. Furthermore of 45 firms, only 11 firms that has received CGPI awards. The majority of sample has 7 members of board of director, meanwhile the independent commissioner, on average, is about 42.68% of the board of commissioner.

| Variable | N   | Mean    | Median  | Std. Deviation |
|----------|-----|---------|---------|----------------|
| ROA      | 135 | 7.8411  | 5.5100  | 8.4914         |
| CGPI     | 135 | -       | 0       | 0.4142         |
| BSize    | 135 | -       | 7       | 2.1006         |
| INEC     | 135 | 0.4268  | 0.400   | 0.1283         |
| FSize    | 135 | 10.4271 | 10.1847 | 1.3486         |

As prior studies (see section 2 Theoretical Framework) show that the implementation good corporate governance (GCG) is related positively to firm performance in the market. This study assumes that the CGPI awardees have GCG practiced in the market. Therefore, this study also tests the differences of ROA averages between the CGPI awardees and non-CGPI awardees in the research sample. The test result is presented in table 2 below.

| Sub-sample      | N   | Average ROA (%) | t-test  | Man-Whitney test (Z-test) |
|-----------------|-----|-----------------|--------|--------------------------|
| CGPI awardee    | 29  | 4.6990          | -2.2840*** | 3.209***                 |
| Non-CGPI awardee| 106 | 8.7008          | (0.0100) | (0.0000)                 |

Notes:***significant at α = 0.01

Unexpectedly, Table 2 shows that average ROA of the awardees is much lower than the non-awardees, almost a half. Therefore, unsurprisingly, the two tests, t-test (parametric) and Man-Whitney test (non-parametric) have consistent results. Both results show significant mean difference, implying that the non-awardee has a higher average operational performance compared to their counterparts. The result is supported by the correlation analysis as shown in Table 3.

| Variable | ROA    | CGPI  | BSize | INEC  | FSize  |
|----------|--------|-------|-------|-------|--------|
| CGPI     | -0.1943** | 1     |       |       |        |
|          | (0.024) |       |       |       |        |
| BSize    | -0.0315 | 0.4116*** | 1     |       |        |
|          | (0.7173) | (0.0000) |       |       |        |
| INEC     | 0.065  | 0.1865** | 0.276*** | 1     |
|          | (0.4537) | (0.0304) | (0.0012) |       |
| FSize    | -0.3357*** | 0.5704*** | 0.5587*** | 0.2472*** | 1     |
|          | (0.0001) | (0.0000) | (0.0000) | (0.0038) |       |

Notes:***significant at α = 0.01
**significant at α = 0.05
The CGPI-ROA correlation coefficient is negative indicating that the CGPI awardees have lower ROA compared to their counterparts. This supports the earlier test of ROA means difference between the awardee group and the non-awardee group. Table 3 also shows that other control variables have insignificant correlation coefficients, except for size. Furthermore, the correlation matrix shows that no multicollinearity problem found in the data.

Next, is the discussion of regression analyses results used to test the research hypothesis (see table 4). Table 4 presents the regression coefficients and t-stat of the hypothesis tests. Column 2 of Table shows the simple regression of the main independent variable, CGPI. It shows a negative significant coefficient. The result infers similar conclusion about the relationship of CGPI awardees and their operational performance. On average, the awardees have significant lower ROA, compared to the non-awardee. The result is contradicted to our hypothesis. We argue that there is still a big gap between the CG reports and how it is implemented in the firms. In order to get the good report, many efforts should be done by firms. Therefore, we also argue that, in the light of that company reporting cost is not cheap, the CG reporting costs put additional expenses to firms. Hence, it results in lower ROA compared to firms do not put much efforts on the reports.

| Variable | ROA (1) | ROA (2) | ROA (3) | ROA (4) |
|----------|---------|---------|---------|---------|
| CGPI     | -4.0018** | -4.67354** | -0.8508 |
|          | (-2.28) | (-2.42) | (-0.42) |
| BSize    | -       | 0.1414  | 0.8351** |
|          |         | (0.36)  | (2.09)  |
| INEC     | -       | 6.4632  | 8.5566  |
|          |         | (1.10)  | (1.54)  |
| FSize    | -       | -       | -2.8935*** |
|          |         |         | (-4.3200) |
| Constant | 8.7008*** | 5.0516  | 28.4307*** |
|          | (10.7100) | (1.5400) | (4.4900) |

On column 3, CGPI coefficient remains negative and significant, even though the model is controlled by other CG aspects (board size and independent commissioner). However, the significance disappears when the model includes company size into the equation (see Column 4). Board size appears to be positively and significantly related to ROA. The adj R-square also increases dramatically when the model incorporates firm size.

The CGPI appears insignificant when the firm size is included in the model (see table 4 column 4). Its explanatory power is taken over by the board and firm size. Size matters more on firm’s operational performance rather than CG indicator. Somehow, it confirms the stewardship theory which states the managements have a function as a steward of the governance to result in better firm’s performance.

Further analysis that is presented in table 5 show that BSize median, then, INEC, and FSize means difference between the awardee and the non-awardee. Surprisingly, the result show that on average the awardees have bigger board of directors, higher percentage of independent commissioner, and larger firms. The results re-affirm that the awardees made significant efforts to put CG measures in place that might result in additional expenses to the firms, hence lower net income and ROA, subsequently.
Based on the regression results, the board of commissioners’ independency has a positive but insignificant relationship to firm performance. This could be due from the fact that OJK requires a minimum proportion of 30% for independent board of commissioner’s members [35]. Our result is contrary to previous studies that found a significant positive effect of board of commissioners’ independency on company’s performance [9], [10] and on corporate value [17]. Regarding the size of board of director, our finding is in line with prior research which found positive significant influence on firm performance [10], [11], [13] and in contrast with findings from Rostami et al. [12] and Zabri et al. [34] that observed a negative relationship between board of director’s size and firm performance. Our result can also be explained by borrowing the result of a prior study that suggested an inverted U-shape relationship between board size and firm performance [6]. This indicates that up to a certain point where the optimum board size number is achieved, having too many members on the board could be disadvantageous for the company.

Table 5. Hypothesis Testing Results Difference Between Awardees and Non-Awardees

| Panel A | Sub-sample | N  | Median BSize | Man-Whitney test (Z-test) |
|---------|------------|----|--------------|--------------------------|
| CGPI awardee | 29 | 9  | -4.114***     | (0.0000)    |
| Non-CGPI awardee | 106 | 7  |             |                          |

| Panel B | Sub-sample | N  | Average INEC | t-test | Man-Whitney test (Z-test) |
|---------|------------|----|--------------|--------|--------------------------|
| CGPI awardee | 29 | 0.4724 | 2.3637***   | 2.893*** (0.0040) |
| Non-CGPI awardee | 106 | 0.4143 | (0.0110) |                          |

| Panel C | Sub-sample | N  | Average FSize | t-test | Man-Whitney test (Z-test) |
|---------|------------|----|---------------|--------|--------------------------|
| CGPI awardee | 29 | 11.8923 | 5.6373***   | 5.116*** (0.000) |
| Non-CGPI awardee | 106 | 10.0263 | (0.000) |                          |

Our finding that suggests non-significance impact of CGPI to firm performance is similar to Epps and Cereola’s [31], who found CGQ rating to be insignificant towards ROA and ROE of companies. Our result also shows resemblance to a recent study that did not found any significant effect of CGPI to ROA in LQ45 firms [36]. Our result is in contrast with Wahyudin and Solikhah [23], who found that even though CGPI has no effect on company growth and market price, it still influences companies’ financial performance, one of which is ROA. The difference in result could result from the measurement used for CGPI, in which they used CGPI score in contrast to CGPI dummy in our current study. In addition, our finding is also contradictory to those of Ghalib [7] and Taufik et al [16] that concluded a significant effect of CG rating and index to company’s profitability, as measured by ROA, among others. Overall, this study proposes that the efforts put forward by companies to implement GCG practices comes at a cost of their profitability (ROA). However, it could be argued that the outcome of implementing GCG practices would benefit the company in the long run, in a form of increased company’s value.

To check the impact of the GCG practices in the long run, this study conducts the time lag OLS regression. The result is presented in table 6 below. Table 6 shows the overall result of CGPI impact on the company performance, 1 year after a company received the award. Furthermore, the effect of board size loses its significant impact on the longer-term performance, while firm size remains the main driver of the company operational performance. This result re-confirms our argument that putting GCG mechanisms in practice, as represented by the rigorous CGPI assessment process, incur significant additional costs for the companies, which adversely impact their performance.
Table 6. Regression Analysis Result on ROA<sub>t+1</sub>

| Variable | ROA<sub>t+1</sub> (1) | ROA<sub>t+1</sub> (2) | ROA<sub>t+1</sub> (3) | ROA<sub>t+1</sub> (4) |
|----------|----------------------|----------------------|----------------------|----------------------|
| CGPI     | -4.2006* (-1.80)     | -5.0298* (-1.95)     | -1.7574              |
| BSize    | -                    | 0.2046 (0.40)        | 0.7775               |
| INEC     | -                    | 6.942 (0.89)         | 8.5969               |
| FSize    | -                    | -                    | -2.4033** (-2.57)    |
| Constant | 8.60324*** (8.02)    | 4.3241 (0.99)        | 23.6516*** (2.74)    |
| Adj R-Square | 0.0245 | 0.0152 | 0.0755 |
| F-stat   | 3.24*                | 1.46                 | 2.82**               |

5. Conclusion
This study aims to examine the impact of CGPI award on firm’s operational performance. The CGPI award is granted to firms that put efforts to report GCG practiced on place. The analysis shows a surprising outcome that the awardees, somehow, show significant lower operational performance. This study argues that the lower performance is due to additional expenses to put GCG on place, as well as, making good CG reports. After controlling for other CG aspects and firm size, board size is positively related to firm’s operational performance, meanwhile firm size has a negative impact to company’s operational performance. This study concludes that the awardees put management as a steward and govern the firms to grow in size, however it comes with a certain cost that reduces their profitability.

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