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THE RELATIONSHIP OF CORPORATE PERFORMANCE FACTORS TO CORPORATE GOVERNANCE

Fanny Soewignyo
fanny_soewignyo@yahoo.com
Fakultas Ekonomi, Universitas Klabat

This study is motivated by the important needs for research to inform current corporate governance debates. Focusing on listed Indonesian financial sectors in year 2009, this study aimed to empirically determine the relationship of corporate performance factors to corporate governance. A corporate governance index based on five aspects of corporate governance was used, and the three different performance measures were considered as independent variables utilized as proxy of corporate performace. All listed sub-sectors under finance sector in Indonesia Stock Exchange (IDX) were included in this study. The results reveal that, earnings per share is positive significantly related to corporate governance, asset turnover is negative significantly related to corporate governance, but market to book value is not significantly related to corporate governance. Moreover, the results indicated that earnings per share is more important than asset turnover in predicting corporate governance.

Keywords*:* *asset turnover, corporate governance, corporate performance, earnings per share, Indonesia, market to book value*

INTRODUCTION

Corporate performance (CP) is a term frequently used by various stakeholder groups, scholars and policy makers alike. According to Kajola (2008), CP is an important concept that is related to the way and manner in which financial resources available to an organization are judiciously used to achieve the overall objective of the organization. It keeps the organization in business and creates a greater prospect for future opportunities.

There are many different ways to measure corporate performance, but all measures should be taken in aggregation as Dutta and Reichelstein (2005) explained that an optimal performance measure must rely on both accounting and stock price variables. Stock price is not only essential in providing investment incentives, but also for filtering out some of the variability in investment returns. Moreover, Barton, Hansen, and Pownall (2010) found that no single measure dominate around the world when they examined the value relevance of a comprehensive set of summary performance measures. Financial performance term is also used as a general measure of a firm's overall financial health over a given period of time, and can be used to compare similar firms across the same industry or to compare industries or sectors in aggregation.

The interest in corporate governance has created healthy debate and dialogue over the role of the corporation, the relationship between the state and the corporation, and the measures needed to improve corporate governance. Corporate governance has been identified as one of the important tools needed in managing any organizations. It is a process for ensuring proper accountability, probity and openness in the conduct of an organization's business. Its initial focus was on the way in which individual corporation is directed and controlled. In general, good corporate governance (GCG) involves management judgment and is essentially voluntary in nature. However, the term 'Corporate Governance' has no single formal definition, and is often therefore defined in several ways (Turner, 2009).

GCG practice has been more strongly emphasized since the recent cases of financial scandals around the world and the recent collapse of major corporate institutions in the most developed financial market, the USA, South East Asia, Europe and Nigeria such as Adelphia, Enron, World Com, Commerce Bank, ABB, Vivendi, Parmalat, Shell, and XL Holidays. Although not identical, one commonality in a large majority of these cases relates to questionable and in some cases even fraudulent, accounting practices. The fact that accounting practices tie many of these episodes together is in large part a result of the business environment of the late 1990s in which these and other companies operated. These scandals have shaken investors' faith in the capital markets and the efficacy of existing corporate governance practices in promoting transparency and accountability (Chan and cheung, 2008; Kajola, 2008). Thomson and Jain (2006) found that problems existed in the culture, the controls and the management of risk in this organization for some years.

This paper is motivated by the important needs for research on CP and its relations with GCG to inform current corporate governance debates. The application of GCG is believed to be capable of strengthening the company's competitive position, efficiently and effectively managing resource and risk, and increasing corporate value and trust among investors, and corporate competitiveness in a sustainable manner. According to Kajola (2008), more research is needed to contribute to the ongoing debate on the investigation of the relationship that may exist between corporate governance mechanisms and firm performance.

Indonesian financial sector is an interesting case for examining the relationship of CP and GCG. The country still grew at a healthy rate, making Indonesia one of the fastest growing economies in the G20 League of Nations, which confirms Indonesia's status as a premier emerging economy. The government of Indonesia has adopted short-term (2004-2009) and long-term (2010-2025) industrial development plans to transform Indonesia into an industrialized economy (Frost and Sullivan, 2010). Moreover, the financial sector is now at the top of the Indonesian government policy agenda. According to Bank Indonesia (2009), the global financial crisis was the major source of instability even though its impact in Indonesia was not particularly significant. The crisis' persistence brings the potential of shocks and intense pressures to the domestic financial sector.

Based on the relevant theories and principles the researcher would choose a number of coporate performance variables that are expected to be strongly related to the corporate governance. The knowledge on the relationships between corporate performance variables and corporate governance could enhance the ability of investors to make decision in their investment.

LITERATURE REVIEW

Corporate Performance. The choice of performance measurement is critical to every company in any industry. Selection of performance measurement system involves a complex interplay between strategy, the firm's internal and external environment, and to determine the relative importance of various measures of performance. The company must take into account all relevant factors for making short-term and long-term decisions.

Neerly, et al., as cited in Veltri (2009), define performance measure as a metric used to quantify the efficiency and/or the effectiveness of an action. The efficiency measures are productivity measures, variously calculated, but based in any case on accounting measures. The effectiveness measures, a proxy measure of value, can be distinguished in profitability measures, based on accounting and/or financial data. Market measures based on market data and mixed measure. A particular case of market measures, which measure the level in which company market value is exceeding its book value. Each of these categories has its pros and cons. The accounting measures are easy to apply, available, certified by auditors but are focused on past events. Market measures, which take into consideration the economic risk and the economic value of growth opportunities, are not free of criticism, including the minor certainty of the data, due to political and social events can distort the market values.

Corporate Governance. There are many different models of corporate governance in the world. The corporate governance model adopted in the United States, the United Kingdom, Australia, Canada, and many other European and Asian countries is the unitary board model (Rebeiz and Salameh, 2006). Indonesia has historically complied with the OECD's Corporate Governance Principles. Indonesia has an elaborate system of corporate governance rules. This system includes the original *Code of Good Corporate Governance* of Indonesia developed in 2001, which was updated and re-issued by the National Committee on Governance in 2006. The principal law governing stock corporations in Indonesia is the *Limited Liability Company Law No. 40 of 2007*, whereas stock markets are mainly regulated under the *1995 Capital Market Law No. 8*, which is expected to be amended by a draft law under development. However, the ROSC notes that actual corporate governance practices in Indonesia often fall short of OECD's recommendations. A 2006 OECD report states that awareness of the importance of corporate governance has increased considerably in Indonesia. Regulations regarding roles of independent commissioners (supervisory directors) have been introduced to improve board practice and strengthen the protection of non-controlling shareholders (eStandardsForum, 2009).

According to the National Committee on Governance (2006), GCG of Indonesia, hereinafter called the GCG Code, is a living instrument offering standards as well as guidance for companies to implement GCG with the purpose of:

1. Achieving sustainable growth of the company through a management system based on the principles of transparency, accountability, responsibility, independence and fairness.
2. Empowering the function and independence of each company organ, namely, the Board of Commissioners, the Board of Directors and the General Meeting of Shareholders.
3. Encouraging shareholders, members of the Board of Commissioners and members of the Board of Directors to take decisions and actions based on high moral values and compliance with the law and regulations.
4. Stimulating the company awareness of social responsibilities in particular the environmental and societal interests of the communities in which a company operates.
5. Optimizing the value of a company for its shareholders by also taking into consideration the interests of other stakeholders.
6. Enhancing the competitiveness of a company, both nationally and internationally, in order to enhance market confidence which may promote investment flow and a sustainable national economic growth.

According to OECD (2004), there is no single model of GCG. Board structures and procedures vary both within and among OECD countries. Some countries have two-tier boards that separate the supervisory and the management functions into different bodies. Such systems typically have a "supervisory board" composed of non-executive board members and a "management board" composed entirely of executives. Other countries have "unitary" boards, which bring together executive and non-executive board members.

The management of a limited liability company (PT) in Indonesia is adopting a two board system (called the two-tier board system), namely the Board of Commissioners and the Board of Directors, each of which has a clear authority and responsibility based on their respective functions as mandated by the articles of association and laws and regulations. (National Committee on Governance, 2006). The Board of Commissioners performs the supervisory and advisory roles, and the Board of Directors performs the executive role.

The Indonesian *Company Law of 1995* is the most important framework for the current legislation on corporate governance in Indonesia. Under the *Company Law*, a company is a separate legal entity in which Directors (Direksi) and Commissioners (Komisaris) represent the company (FCGI, 2006). The general structure of a company named PT in Indonesia is as follows:

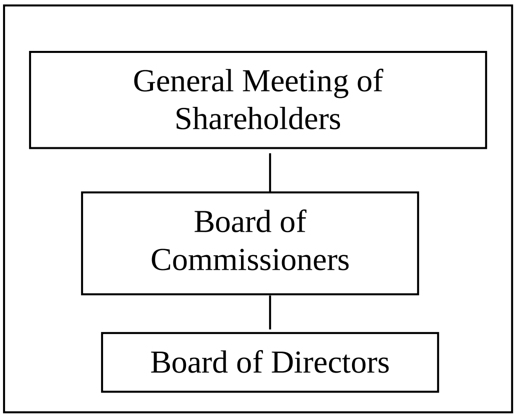

Figure 1. General Structure of a Company in Indonesia
(FCGI, 2006)

Board of Commissioners. The board of commissioners shall function and be responsible collectively for overseeing and providing advice to the board of directors and ensuring that the company implements the GCG. However, the board of commissioners is prohibited from participating in making any operational decision. Each of the members of the board of commissioners, including the chairman, has equal position. (National Committee on Governance, 2006).

The board of commissioners (Komisaris) has to supervise and advise the directors in the running of the company. This board is required by the Company Law to carry out, in good faith and with full responsibility, its duties in the best interests of the company. It is empowered by law to suspend a director and must sign, together with the board of director, the annual report of the company. Thus, it shares legal responsibility for misleading financial statements therein causing a loss to any party there from. Each member of the board of commissioners must disclose to the company, by virtue of the *Company Law*, any shareholding interests held by that member or his family in the company or other companies (FCGI, 2006). In two tier board systems the supervisory board is also responsible for appointing the management board which will normally comprise most of the key executives (OECD, 2004).

The composition of the board of commissioners shall be of sufficient size that suits the complexity of the business of the company by taking into account the effectiveness in decision-making. The board of commissioners may consist of commissioners who are not originated from an affiliated party, known as independent commissioner. The number of independent commissioners shall be such, so as to ensure that the control mechanism runs effectively and in accordance with laws and regulations (National Committee on Governance, 2006). More specifically, Indonesia Stock Exchange (IDX) requires the listed companies to have independent commissioners at least thirty percent (30%) of the composition of the board of commissioners who can be firstly appointed in general meeting of shareholders held prior to listing and shall be effective after the shares of the company are listed (Jakarta Stock Exchange Inc., 2004). For banking institutions, *Bank Indonesia Regulation Number 8/14/PBI/2006* regulates that no less than fifty percent (50%) of the number of the board of commissioners shall be independent commissioners (Bank Indonesia, 2006).

Board of Directors. The company board is responsible to balance the ownership rights enjoyed by shareholders with the discretion granted to managers. GCG requires that the board, whatever its structures, should focus on long-term issues, such as assessing corporate strategy, and activities that might involve a change in the nature and direction of the company, rather than taking on day-to-day operational responsibilities. The board should also be responsible for formulating and disclosing a remuneration policy that highlights the link between remuneration and performance for key executives and board members (OECD, 2005).

In many developed economies with a significant publicly listed company sector, the regulators and corporate governance practitioners have been concerned for some time to improve the effectiveness of boards of directors and other governance mechanisms in the wake of a series of unexpected corporate collapses and massive financial losses to shareholders (Keasey, Thompson and Wright, 2005, chap. 5). Board size might influence the dynamics in board functions. For example, a large and diverse board of directors may increase the board performance in terms of knowledge and skills. On the other hand, this type of board potentially may face group dynamics problems, which in turn makes the board less effective. Smaller boards are more efficient in comparison with more members since it is easier to reach agreements on strategic policies of a company (Ljubojević and Ljubojević, 2008).

Audit Committee. The audit committee is required by SEC regulations (Rebeiz and Salameh, 2006). An effective audit committee can enhance the corporate governance practices of a company. Audit committees are designed to assist boards and individual directors to discharge their duties in relation to internal company controls, reported financial information, and corporate standards of behavior.

The *Code of Good Corporate Governance* of Indonesia states that the audit committee shall assist the board of commissioners to ensure that financial reports are presented appropriately in accordance with the generally accepted accounting principles; internal control structure is adequate and effective; internal and external audits are conducted in accordance with applicable audit standards, and audit findings are followed up by the management. The composition of the audit committee shall be such so that it can accommodate with the complexity of the company by taking into account the effectiveness in decision making. For publicly listed companies, state-owned enterprises, province and region-owned companies, companies that raise and manage public funds, companies of which products or services are widely used by public, and companies with extensive influence on environment, the audit committee is chaired by an independent commissioner and the members may consist of commissioners and or professionals from outside the company. One of the members should have an accounting and or finance background (National Committee on Governance, 2006).

The audit committee is at least comprise of three persons, one of whom will be the independent commissioner of the listed company who is also the chairman of the audit committee, while the other members are the external parties who are independent, at least one of whom must be an expert in accounting and/or finance (Capital Market Supervisory Agency, 2004; Jakarta Stock Exchange Inc., 2004). Experience shows that an audit committee is likely to function most effectively with a small membership of three to six people (Wallace and Zinkin, 2005).

Corporate Performance and Corporate Governance. A large body of literature examined the relationship between corporate performance and corporate governance (*e.g.*, Ali Shah, Ali butt and Hasan, 2009; Balasubramanian, Black, and Khanna, 2010; Dittmar and Mahrt-Smith, 2007). While some studies argue that the causality runs from governance to performance, a number of others demonstrate the reverse (e.g., Aman and Nguyen, 2007). Several empirical studies have investigated the link between corporate governance and corporate performance with positive impact (e.g., Ali shah, Ali Butt and Hasan, 2009; Black, Jang and Kim, 2006; Dittmar and Mahrt-Smith, 2007 and Doucouliagos and Hoque, 2005). Ali shah, Ali Butt and Hasan (2009) noted that better governance is supposed to lead to better corporate performance by preventing the expropriation of controlling shareholders and ensuring better decision-making. The study of Black, Jang and Kim (2006) also shows a positive relationship between corporate governance and company's performance. Similarly the study of Dittmar and Mahrt-Smith (2007) revealed that GCG has a substantial positive impact on U.S. firms' value, while Doucouliagos and Hoque (2005) concluded that corporate governance is an important determinant of Australian bank's stock prices. The direct effect on share prices operated through willingness to pay a premium or discount for banks that have good/poor corporate governance characteristics.

Aman and Nguyen (2007) discovered that in Japan, poorly governed firms significantly outperform better-governed firms in market returns. Moreover, Love (2011) surveyed a vast body of literature evaluating the relationship between corporate governance and performance and summarized that there seemed to be no emerging consensus on the nature of the causality and suggested that corporate governance is likely to develop endogenously, that better firm performance leads to better corporate governance. This result suggests further research.

RESEARCH METHODOLOGY

The causal design was used in this study to explain relationships among variables. The concern in causal analysis according to Cooper and Schindler (2006) was on how one variable affects the changes in another variable. In this study, it probes deeply and analyzes the relationship of corporate performance to corporate governance.

The listed financial sectors in general offer an ideal area of corporate performance and corporate governance research, because: (1) there are reliable data available in the form of published annual reports; (2) the participants of stock exchange are deeply concerned with the performance and governance. The classification of the sectors according to IDX is as follows: (1) bank; (2) financial institution; (3)securities company; (4) insurance; (5) investment fund/mutual fund; and (6) others. During the three consecutive years, no company was listed under investment/mutual fund classification.

There were 69 sample companies listed according to IDX as of 2009 but not all companies were used for this study for a variety of reasons. Those companies whose balance sheets degenerated into negative net worth or negative earnings per share and several companies did not submit their annual reports to the IDX were eliminated from analysis. Given these limitations and constraints, all other remaining companies were selected which yielded a final sample of 45 companies.

Data Collection. This study used secondary data: annual reports of the listed Indonesian financial sector, IDX statistics and stock prices, which were available in the Indonesia Stock Exchange (IDX) website. Data needed to derive corporate performance measures as independent variables were standard financial numbers that were available from audited financial reports of companies as part of the annual reports except the data for market capitalization which were found from IDX statistics. Data for market capitalization were reconfirmed with number of shares outstanding according to the annual report and the stock price.

Measure of Variables. The three different corporate performance measures used in this study are: EPS ratio, ATO ratio, and MB ratio. Corporate governance as dependent variable in this study was measured by the good corporate governance index (GCG Index) resulted from five aspects combined into one measure (see Table 1).

Table 1 Summary variables and their proxy measure determination

EPS $ratio_i$	Earnings per share ratio	$\frac{\text{EPS of company i}}{\text{Weighted mean EPS of the 45 companies}}$
ATO $ratio_i$	Asset turnover ratio	$\frac{\text{ATO of company i}}{\text{Weighted mean ATO of the 45 companies}}$
MB $ratio_i$	Market to book ratio	$\frac{\text{MB of company i}}{\text{Weighted mean MB of the 45 companies}}$
EPS	Earnings per share	$\frac{\text{Earnings available to ordinary shareholders}}{\text{Number of ordinary shares in issue}}$
ATO	Asset turnover	$\frac{\text{Net sales}}{\text{Total Assets}}$
MB	Market to book value	$\frac{\text{Market capitalization}}{\text{Book value of the total net assets}}$
GCG $Index_i$	Good Corporate Governance Index	BODSize $ratio_i$ + BOCSize $ratio_i$ + BOCIndp $ratio_i$ + ACSize $ratio_i$ + ACIndp $ratio_i$
BODSize $ratio_i$	Ratio Board of Director Size	Board of director size of company i divided by weighted mean board of director size of the 45 companies
BOCSize $ratio_i$	Ratio Board of Commissioner Size	Board of commissioner size of company i divided by weighted mean board of commissioner size of the 45 companies
BOCIndp $ratio_i$	Ratio proportion of independent commissioners in the composition of board of commissioners	Proportion of independent commissioners in the composition of board of commissioners of company i divided by weighted mean proportion of independent commissioners in the composition of board of commissioners of the 45 companies
ACSize $ratio_i$	Ratio audit committee size	Audit committee size of company i divided by weighted mean audit committee size of the 45 companies
ACIndp $ratio_i$	Ratio proportion of independent commissioners in the composition of audit committee	Proportion of independent commissioners in the composition of audit committee of company i divided by weighted mean proportion of independent commissioners in the composition of audit committee of the 45 companies

Statistical Tools Used. To determine the relationships of corporate performance to corporate governance, multiple regression analysis was conducted using cross-sectional data. Multiple linear regression was used to determine if several continuous independent variables are significant predictors of a continuous dependent variable. The multiple linear regressions model is presented as

$$CG\ Index_i = b_0 + b_1 EPS\ ratio_i + b_2\, ATO\ ratio_i + b_3\, MB\ Ratio_i + u$$

where b_0 is the intercept of the model which is equal to the value of the dependent variable when the independent variable is equal to zero, b_1, b_2 and b_3 are the coefficients for the independent variables and indicate how many units change there is in the dependent variable for every one unit increase in the independent variable when controlling for the other independent variables in the model. *u* is the random error term that is normally distributed with a mean of zero and a constant variance (Salvatore and Reagle, 2002).

The coefficient of multiple determination (Adjusted-R^2*)* was used as an adjustment for the fact that when one has a large number of independents. *Adjusted-*R^2 is defined as the proportion of the total variation in $CG\ Index_i$ explained by the multiple regression of $CG\ Index_i$ on $EPS\ ratio_i$, $b_2\ ATO\ ratio_i$, and $MB\ Ratio_i$. *F-test* was used to test the overall significance of the regression. If probability (*F*) < 0.05, then the model is considered significantly better than would be expected by chance. In addition to the overall *p* value, multiple regression also reports an individual *p*-value for each independent variable. A low *p*-value here means that this particular independent variable significantly improves the fit of the model.

Linearity assumption was verified through examination of scatter plots of residuals that indicates linear relationship between the independent variable (s) and the dependent variable. Normality of the error term distribution was used to check if the data are normally distributed. According to Chan (2003), small samples of n<30 always assume not normal and moderate sample are 30-100. Since the sample size of this study n > 30, the sampling distribution of the mean is approximately normal.

Results and Discussions. From the total of 45 companies used as sample for this study, there were only 44 companies which were used for analysis as one outlier was detected and it was removed from the analysis. The finding suggests that using the three indicators of corporate performance (EPS Ratio, ATO Ratio and MB Ratio) to check which of the three indicators is relatively more important than the others to predict GCG (see Table 2) and to check for the absence of multicollinearity problem between the independent variables, the Pearson correlation matrix is presented in Table 3.

The result in Table 2 indicates that with the acceptance of a significant level of 0.05, the *F*-statistics suggests the overall model is significant ($p < 0.05$). Turning to the significance of each independent variable, the *t*-statistic and *p*-value suggest that EPS Ratio is positive significantly related to GCG, $p < 0.05$ and ATO Ratio is negative significantly related to GCG, $p < 0.05$, but MB ratio is not significantly related to GCG Index, $p > 0.05$. The result indicates that EPS Ratio (Std. $\beta = 0.434$) is more important than ATO Ratio (Std. $\beta = -0.272$) in predicting GCG. This result has the support with the question in Love (2011) of the nature of relationship between corporate governance and performance. While some studies argue that the causality runs from governance to performance, a number of others demonstrate the reverse.

Table 2 Multiple Regression Result – EPS Ratio, ATO Ratio and MB Ratio to Corporate Governance (GCG Index)

Dependent Variable: GCG Index

Independent Variables	Coefficient	Std. Beta	*t*-value	*p*-value *
Intercept	4.57		14.29	**0.00**
EPS Ratio	0.47	0.434	3.38	**0.00**
ATO Ratio	-0.38	-0.272	-2.17	**0.04**
MB Ratio	0.41	0.252	1.88	0.07
R^2	**0.44**			
Adj. R^2	**0.39**			
F – value	**10.26**			
Prob. *(F)*	**0.00**			
No. of companies/observations	44			

* Significant at the 0.05 level

Table 3 shows the Pearson correlation matrix for all the independent variables (EPS Ratio, ATO Ratio and MB Ratio). It can be observed that the correlations between the independent variables are not high. They range from a low of -0.290 to a high of 0.349. Consequently, it can be presumed the absence of any multicollinearity problems.

Table 3: Pearson Correlations

	EPS Ratio	ATO Ratio	MB Ratio
EPS Ratio	1.000	**0.033**	**0.349**
ATO Ratio	**0.033**	1.000	**-0.290**
MB Ratio	**0.349**	**-0.290**	1.000

CONCLUSIONS

The purpose of this research is to examine the importance of the three corporate performance indicators, namely earnings per share ratio, asset turnover ratio, and market to book ratio to corporate governance, which includes board of director size, board of commissioners size, proportion of independent commissioners in the composition of board of commissioners, audit committee size, and proportion of independent commissioners in the composition of audit committee.

Using financial sectors listed on Indonesia Stock Exchange (IDX), the results of this study show that the level of corporate governance is directly related to earning per share but inversely related to the asset turnover and not significantly related to market to book value. The findings of this study can add to the existing body of the literature, and can serve as a starting point on which future studies can be done. Future studies could add other measures of corporate performance and some other measures of corporate governance. Possible areas of future research in Indonesia can also focus on other industries.

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