CHAPTER I
INTRODUCTION

1.1 Study Background

According to *Jean-Paul Page, CFA*, University of Sheerbrooke, corporate governance is consisting of the legal, contractual, and implicit frameworks that defines the exercise of power within a company, that influences decision making allowing the stakeholders to make an assumption on their responsibilities, and to make certain on the point that their privileges and rights are appreciated. Based on those definition, it is expected that corporate governance involves exercising power to create true economic value within certain limits and constraints.

Based on the traditional definition of governance, the power is delegated by the board of directors, which acts on behalf of and in the interest of the shareholders. Because shareholders usually do not have the special ability to manage the company, therefore, they delegate the responsibility to people who can manage it well. That is why at this point that legal and regulatory constraints intervene to reconcile the interests of the principals and the agents itself (Page, 2005:2). For example, corporate law is founded on the director's obligation to act as a "prudent administrator," which requires him or her to act with prudence and diligence so as not to bring the company to unnecessary risks. In other words, the agents and principals have to manage the risk in such a well-prepared risk so that the company that they run will sustain.

Corporate governance is very important to company's sustainability issue. As Claessens & Yurtoglu (2013) argued that during Asian financial crisis in 1997, many companies that the corporate governance is weak had face the high level of dropped in their shareholders value. For those who involved in the global financial crisis in 2007, it brings an emerging issue that risk-related subject has been increasing rapidly (Venuti & Alfiero, 2016). Risk-taking done by the executives is controlled by some stakeholders within company, such as board of directors, audit committee, and also shareholders itself.

Some of the components of corporate governance to be discussed in this research are audit committee, managerial compensations, ownership concentration and also size of the board. Those variables will determine whether corporate governance affects the risk-taking within company. Among all variables, they have relationships that can influence the executives as a decision maker in operational activities to take risks in the company. The board of director size which includes outside, executive and non-executive directors sometime also own the company and contribute to the ownership concentration. Thus, aside they got compensations, they will also determine the compensations that lower level executives can obtain in order to make sure that the performance of the company is growing perpetually.

Some studies have already examined the effect of corporate governance to the firms' risk-taking. The study of Venuti & Alfiero in 2016 had attempts to develop an empirical research on the nature and consequences of corporate governance on Eurozone Insurance Industry risk-taking attitude. They found that most of the findings provide negative significant correlations except for the company dimension and technical reserves that provide a positive significant correlation. The other study by Eling and Marek in 2014 had found that the higher levels of compensation increased monitoring (more independent boards with more meetings), and more block holders are associated with lower risk-taking in U.K and German insurance markets.

To extend more understanding, there is also a research done by Nguyen (2011) who examined the influence of corporate governance on the risk-taking of Japanese firms. The results of the study showed that family control and ownership concentration are associated with higher risk-taking, whereas bank control has the opposite effect. Koerniadi *et al* (2014) examined the impact of firm-level corporate governance practices on the riskiness of a firm's stock returns in a setting that can be considered as less conducive to managerial risk-taking. Their findings showed that block holding has a positive and statistically significant impact on risk-taking and is also consistent with the view that smaller board of director sizes are associated with higher risk-taking. Finally, concentrated shareholding by insiders is associated with lower levels of risk-taking.

Huang and Wang (2015) studied that corporate governance reform in China offers an interesting context for investigating the systematic relationship between board of director size and firm's risky policy choices. The results of their study indicated that firms with smaller boards experience larger variability in future firm performance which will affect the higher risk-taking of the corporate.

Venuti and Alfiero in 2016 had tested the ownership concentration, the managerial compensation, the number of board of directors and also the gender and nationality diversity of board of directors in a company toward the corporate risk-taking behavior. For the last variable, it is still arguable because the results from study are still inconclusive. Even a study done by Firdaus and Adhariani (2017) showed that there is no relationship between board of directors' gender diversity and corporate risk-taking in Indonesia. Firdaus and Adhariani believed that it happens because of the relatively low percentage of the variable. Therefore, the researcher chooses not to use the variable of gender and nationality diversity in this research. Besides, the researcher adds one variable represented by the audit committee due to the important role that they have within a firm. The existence of audit committee can perform important corporate governance functions, such as strengthening board of directors' independence, especially outside directors, providing advice to the operational of the company, and of course auditing (Adams & Jiang, 2016). Their contribution in advising operational activities can lead to risk management done by the executives of the company.

In research done by Venuti and Alfiero (2016), they used insurance industries as the sample of the research. Meanwhile, this research was taking the sample of manufacturing company. The researcher used only one sector of industry, which is manufacturing company, to avoid complications from the differences in the characteristics of firms engaged in different industries. Furthermore, the other reason that the researcher used manufacturing companies was because in a developing country with an emerging market like Indonesia, the manufacturing company is very important and also can give a high contribution to the economics of the country. The manufacturing company has significantly promoted industrial development in Indonesia and also give high contribution to the national GDP from 1970 to the present day (Langit & Adhariani, 2018). Besides, the number of manufacturing sector in Indonesia is the highest toward the other sectors so that the data will be easier for the researcher to collect. Manufacturing companies used as the sample were the companies listed in Indonesia Stock Exchange for the period of 2013-2017. The 5-years period used in this research because it can give more accurate information on the condition of the company. Besides, the period used was relatively recent to maximize the degree of relevance of the data result. Furthermore, 5-years period used in this research was based on John, Litov, & Yeung (2008) who required the measurement of risk-taking is based on the companies with available earnings and total assets for at least five years. The other reason to use the period of 2013-2017 is the establishment of the Indonesia Securities Investor Protection Fund (ISIPF) in the December of 2012 which gives sign that risk management is important for the company listed in the Indonesia Stock Exchange.

This study is aiming to find out and analyse the relationship of corporate governance and the corporate risk-taking in Indonesian manufacturing companies. With this study, it is hoped that the users of this research can have value added on their knowledge.

1.2 Research Problem

A lot of studies have examined the relationship between corporate governance in a company and the financial performance. On the other hand, there is only a few of the research studied on the effect of corporate governance on the company's risk-taking decision. It needs to be studied by the researcher about the components in corporate governance such as audit committee size, board of director size, managerial compensations, and ownership concentration and the impact on company's risk-taking. Thus, the problems that the researcher will discuss in this research are whether board of director size, managerial compensations, audit committee and ownership concentration will affect the corporate risk-taking.

1.3 Research Objective

This research is aiming to investigate the effect of corporate governance, represented by some components on company's risk-taking, whether it has a positive or negative correlation. Thus, the objective of this research is to analyse the effect of board of directors' size, managerial compensations, audit committee, and ownership concentration to corporate risk-taking.

1.4 Research Contribution

This study is hopefully can contribute both theoretically and practically. Theoretically, this study is expected to be able to help the understanding of elements that can affect the risk-taking decision within the firm, especially for the Indonesian manufacturing firms.

Practically, the users of the annual reports (shareholders, labour union, government, and others) can take the advantage of this research because the results will show what aspects affecting the risk-taking decision. This research is also hoped to help them analyse the results which lead them to choose what decisions that they should make.

1.5 Systematic Writing

This research used scientifically writing system, which consists of five chapters, they are:

CHAPTER I INTRODUCTION

The first chapter cover the introduction section, which explained the background of the study, the research problem, the research objectives, and the contribution of this research.

CHAPTER II LITERATURE REVIEW

Chapter two explained the concept that is used to support and clarify the discussion associated with the theory that lie within it. This chapter explained the formulation of hypothesis based on the theory and review of the previous study.

CHAPTER III RESEARCH METHOD

This chapter explained the population and sample, the data sources and techniques in collect the data, research variables and its measurements, and the methods of data analysis.

CHAPTER IV RESULTS AND DISCUSSIONS

This chapter explained the results of the data that have been collected and processed by the researcher. Besides, the discussion of test results is explained in this chapter.

CHAPTER V CONCLUSION, LIMITATION, AND SUGGESTION

In the final chapter, the conclusion derived from the discussion of analysis in previous chapter. Then, the limitation also disclosed if the researcher found any limitations during the research process. The suggestion is provided for the next research in this particular field of study.