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The Role of Internal Function of Organization for The Successful Implementation of Good Corporate Governance

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***Abstract*—**The inability to implement the principles of good corporate governance (GCG) as demonstrated in the surveys is due to a number of constraints which can be classified into three; namely *internal constraints*, *external constraints*, and constraints coming from the *structure of ownership.* The issues in the internal constraints mentioned are related to the function of several elements of the company. As a business organization, corporation is unable to achieve its goal to successfully implement GCG principles since it is not support by its internal elements' functions. Two of several numbers of internal elements of a company are *ethical work climate* and *leadership style of the top management.*

To prove the correlation between internal function of organization (in this case ethical work climate and transformational leadership) and the successful implementation of GCG principles, this study proposes two hypotheses to be empirically tested on thirty surveyed organizations; eleven of which are state-owned companies and nineteen are private companies. These thirty corporations are listed in the Jakarta Stock Exchange. All state-owned companies in the samples are those which have been privatized.

The research showed that internal function of organization give support to the successful implementation of GCG principle. In this research we can prove that : (i) ethical work climate has positive significance of correlation with the successful implementation of social awareness principle (one of principles on GCG) and, (ii) only at the state-owned companies, transformational leadership have positive significance effect to forming the ethical work climate.

***Keywords*—**Good Corporate Governance Principles, Ethical Work Climate, Transformational Leadership

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I. Introduction

IN Asia, including Indonesia, corporate governance (CG) start to become discussion topics in the middle of the 1997.

In this time, the crisis of economic encumbering the nations of Asia [8]. Different with implementation of CG in the developing countries, Black in the year 2001 told us that implementation of CG in the development countries (like in Asia) have more variations. Because of that variations, CG become one of the factor that is have significant impact for increasing share values of the company [2].

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The condition of the implementation of CG by a number companies in Indonesia can be described as following.

1. The assessment conducted by Credit Lyonnaise Securities (CLSA) since year 2001 up to year 2007 give the low value to most companies in Indonesia in realizing good corporate governance principles (GCG), even in comparison with the other nations of Asia. Marginally, we can separate the assessment conducted by CLSA into two. In the year 2001 until 2003, CLSA doing the assessment of implementation of CG is based on seven following dimensions, i.e.: (i) discipline, (ii) transparency, (iii) independence, (iv) accountability, (v) responsibility, (vi) fairness, and (vii) social awareness. In the year 2004 until 2007, CLSA joint with Asian Corporate Governance Association (ACGA) to assess the implementation of CG from Asian's companies. Different with three previous year, in this year the assessment of implementation of CG is based on five macro dimensions, i.e.: (i) law and practices, (ii) enforce, (iii) political and regulatory, (iv) IGAAP, and (v) culture [5].

   The result of the assessment from 2001 until 2007 can be seen in the Fig.1.

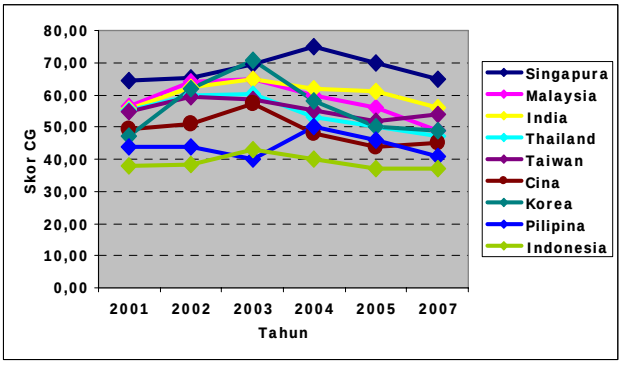


Fig. 1 Result of the assessment from CLSA

2. The result of research from Sulistyanto and Nugraheni show us that the implementation of CG is unable to reduce manipulation of financial reports by public companies which is listed in Bursa Efek Jakarta (BEJ) [18].

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That conditions show us that most companies in Indonesia are unable to attain the principles of GCG because the companies are not implement the CG seriously. That inability is due to a number of constraints which can be classified into three, namely internal constraints, external constraints, and constraints coming from the structure of ownership.

The issues in the internal constraints mentioned are related to the function of several elements of the company. As a business organization, corporation is unable to achieve its goal to successfully implement GCG principles since it is not support by its internal elements' functions. Two of several numbers of internal elements of a company are *corporate culture* and *leadership style of top management*.

The companies usually have corporate code of conduct in order to implement of GCG principle. The corporate code of conduct is articulation of corporate culture and values [14,15]. The corporate code of conduct containing values of ethics and guidance becoming reference in face of costumers, suppliers, contractors, government, and the other participants which is have relationship with the companies. "Envelope culture" and give something to someone are some examples that is arranged in corporate code of conduct. In broader perspective, the corporate code of conduct containing the things that is expressed above and corporate policy about corporate social responsibility [1].

The company can implement the corporate code of conduct eminently if the companies can *built collective perception about what is right based on ethics and how to handle the problem of which is related to ethics from the leaders and all worker*. According to Victor and Cullen in the year 1987, building the collective perception about ethical behavior from entire organizational member of the company is related to ethical work climate [19]. In the other word, the company will have ethical work climate if the company can built the collective perception about ethical behavior.

The leadership style is one of important factor to built organizational climate that wanted because the climate is result of interaction between organizational culture, behavior of the leaders, system, structure, and the other factors in organization. That opinion is expressed by Srivastav in the year 2006 [4].

Shortly, this research is focused to answer two questions which is mentioned below to know the role of two internal function of organization, namely organizational climate and leadership style, in supporting the implementation of GCG principles.

1. How the relationship between ethical work climate and the successful implementation of GCG principles?
2. How the leadership style give its role in building the ethical work climate?

II. Hypothesis and Research Model

A. Ethical Work Climate and GCG Principles

According to Victor and Cullen in the year 1967, there are nine ethical climate which can occur in the organization, i.e. self interest, friendship, personal morality, company interest, team play, rule and procedure, efficiency, social responsibility, and the law or professional code. To be more clearly, we can depict ninth of ethical work climate which is developed by Victor and Cullen as seeing in Table.1 [19].

TABLE I
TYPOLOGY OF ETHICAL WORK CLIMATE FROM VICTOR AND CULLEN

Locus / Aspect	Individu	Local	Cosmopolitan
Egoism	Self interest	Company interest	Efficiency
Benevolence	Friendship	Team play	Social responsibility)
Principles	Personal morality	Rrule and procedures	The law or professional code

In assessment of CG from CLSA, there are some conditions which is depicting the existence of ethical behavior. That conditions are related to the existence of corporate policy that emphasizing at ethical behavior, corporate policy that prohibit children to become employee of the companies, corporate policy about treating all worker in the same way, corporate policy about source of the raw material, corporate policy about environment responsibility, and the existence of policy that prohibit the companies to built relationship with the country that not have legitimacy. All that condition are the items in the social awareness dimension. Shortly, we can say that the companies can fulfill all the items in the social awareness dimension if every leader and worker of the companies have collective perception about what is right based on ethics and how to handle the problem of which related to ethics (ethical behavior). As we mentioned above, the existence of collective perception about ethical behavior is depicting the existence of ethical work climate in the company [11,19].

In assessment of CG from CLSA, value one is given to the item that can fulfill by the companies (see part 3.2.1). Value one that give to items of one dimension will give contribution for increasing the score of that dimension. In this case, value one that given to items in the social awareness dimension will give contribution for increasing the score of social awareness dimension. Shortly, we can hypothesis the relationship between the ethical work climate and the social awareness dimension as seeing below.

Hypothesis 1 Ethical work climate have positive correlation with social awareness score

Social awareness dimension is one of seven dimensions that built the score of CG. Six other dimensions are discipline, transparency, independence, accountability, responsibility, and fairness. All that dimensions can be expressed as GCG principles. According to Cadbury report in the year 1992, the principles of GCG consist of transparency, integrity, and accountability. According to Organization for Economic Corporation and Development (OECD) in the year 2002, the basic principles of GCG consist of fairness, transparency, accountability, and responsibility [8]. According to Letter of Decision from Ministry of Public Companies, number 117/M-

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MBU/2003, the principles of GCG consist of fairness, transparency, accountability, and independency. Pursuant to this matter, the statement in the hypothesis one can be expressed as follow: ethical work climate have positive correlation with one of the principle of GCG, that is social awareness principles.

B. Ethical Work Climate, Leadership Style, and Principles of GCG

In his book which entitles *Leadership and Organizational Climate*, Stringer shows us how that the leader can influence the performance of organization by manipulating the environment of the organization. Memory and shadow of the leaders will create the atmosphere or climate in the organization and that climate will influence energy and effort of someone to act [17]. In line with Stringer, in his research, Schneider conclude that 50 until 70 percent of the workers perception to the work climate is relating to the characteristic of the leader [6].

In the year 2001, Litwin and Stringer are depicting the relationship between leadership, organization climate and performance of organization as seeing in Fig. 2 [16].

Leadership → organizational → motivation → behaviour → result
style climate

Fig.2. Relationship between leadership, organization climate and performance of organization

After studying a number of leadership style, Rouche, Baker and Rose in the year 1989 told us that the transformational leadership is a leader that have capability to influence values, beliefs, and behaviour of subordinate [13]. In line with that statement, Kullanitiwaat in the year 2005 found that the transformational leadership is a leader that has significant influence to built achievement motive, morality reasoning, and organization climate [9].

Thereby, based on statement that have been told by Stringer (2001) [17], Schneider [6], and Litwin and Stringer [16], we can conclude that the transformational leadership is a factor that having an effect on to forming work climate which is desired. Farther, based on statement which have been told by Rouce, Baker, and Rose (the transformational leadership can influence values and beliefs of people in organization) and result of Kullavanitiwat's research (the transformational leadership have significant influence to built morality reasoning), we can conclude that the transformational leadership is the leadership style that able to influence the forming of ethical work climate that emphasize on morality reasoning to determine what is right based on ethics and to handle the problems that related to ethics. Based on those conditions, we can hypothesis the relationship between the ethical work climate and the transformational leadership as seeing below.

Hypothesis 2 The transformational leadership has positive influence to build the ethical work climate.

C. Research Model

Pursuant to hypothesis 1 and hypothesis 2, we can depict this research model as seen in Fig. 3

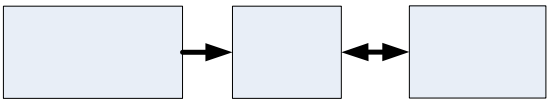


Fig. 3. Research Model

III. Methodology

A. Research Sample

In this study, 2 (two) hypothesis were empirically tested against the 30 (thirty) surveyed organizations, 11 (eleven) stated-owned companies and 19 (nineteen) private companies in manufacture and service. These 30 (thirty) companies are listed in the Jakarta Stock Exchange.

In every companies, questionnaire is addressed to a number elements of the companies that are Board of Commissioner, Board of Director, Functional Committee, Corporate Secretary, and Management (equivalent of division head and section head).

B. Questionnaire Development and Scale of Measurement

- *Questionnaire for Assessing The Implementation of CG*. The implementation of CG is assessed by questionnaire that developed by CLSA in the year 2001 and 2002. In that questionnaire, implementation of CG is assessed through seven dimensions that depicting a set of GCG principles. That dimensions can be grouped to become 3 (three), there are disclosure, non-disclosure, and the other. Dimension which included in the disclosure group is transparency. Dimensions which included in the non-disclosure group are discipline of management, independence, accountability, responsibility, and fairness. Dimension which included in the other group is social awareness. Every dimension has weight. Weight for transparency, discipline, independence, accountability, responsibility, and fairness are 15%; and weight for social awareness is 10%. Every dimension have 7 (seven) until 10 (ten) statement and the analyst is asked to assign value 1 (one) or 0 (zero) to every statement depend on condition of the companies. Value one (1) indicate that the companies can't fulfill the conditions that is expressed in the statement, while value zero (0) indicate that the companies can fulfill the conditions that is expressed in the statement [3]. Aim of usage of binary scale (0 or 1) in this questionnaire is to lessen subjectivity from analyst when the analyst assessing the implementation of CG from one company [5]. Next, value from every statement is summed to form score of

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every dimension. CG score is assessed by dividing score from all dimension with number 57 (fifty seven) which is representing amount of entire question from all dimension [3].

- *Questionnaire for Assessing The Ethical Work Climate*
  The ethical work climate is assessed by questionnaire that developed by Victor and Cullen in the year 1987. Design of this questionnaire is based on ethical work climate typology that have 3 (three) locus (individual, local, and cosmopolitan) and 3 (three) criteria (egoism, benevolence, and principle) (see Table I in the previous page). Egoism is a climate in organization that focused at maximization of self interest. Benevolence is a climate in organization that focused at maximization of joint interest, and principle is a climate in organization that focused at adherence to duties, rules, laws, or standards [19].
  Based on 3 (three) locus and 3 (three) criteria, there are 9 (nine) ethical climate which can be built in the organization; namely *self interest, company interest, efficiency, friendship, stakeholder orientation, personal morality, adherence to rules and laws,* and *public interest* [19].
  Ethical work climate questionnaire use Likert Scale with 6 (six) alternative choices (completely false, mostly false, somewhat false, somewhat true, mostly true, and completely true).

- *Questionnaire for Assessing The Transformational Leadership*
  The transformational leadership is assessed by multifactor leadership questionnaire that developed by Bass and Avolio in the year 1995. In that questionnaire, transformational leadership style is assessed through four dimension that depict main characteristic from the leadership style, namely charismatic behavior, motivation inspirational, intellectual simulation, and individual consideration.
  The transformational leadership use Likert Scale with 5 (five) alternative choices (very disagree, disagree, neutral, agree, and very agree).

IV. Result

Result of test of hypothesis 1 show us that ethical work climate have positive significant correlation with social awareness score (r=0450, *sig.(1-tailed*)<0,1).

In this case, ethical work climate being expected to give support for the company to achieve every condition in the social awareness dimension. Ethical work climate will form collective perception about what is right based an ethics and how to handle ethical problems. That perception will push the company to have policy that emphasize at ethical behavior, prohibit the company to employ the children, treat all worker equivalently, prohibit the company to have relationship with the nation that don't have legitimacy, and also give guidance for the company in purchasing raw material and holding responsible to the environment.

Result of test of hypothesis 2 show different conditions between the states owned company and the private company. In the state owned company, the transformational leadership style give positive significance influence to form the ethical work climate (ETHICAL_WORK_CLIMATE=2,138+0,656* TRANS_LEADERSHIP_STYLE_SOC,*sig*<0,1,R^2=0,602), but in the private company, no significance influence from the transformational leadership to form the ethical work climate (ETHICAL_WORK_CLIMATE=4,432+0,023*TRANS_LEADERSHIP_STYLE_PC,*sig*.>0,1,R^2= 0,06)**.** We can explain condition in the private company through number of foregoing research. A number of research told us that workers in the private companies already have high commitment. The result of research from Zeffane (1995) indicating that commitment's average value from workers in the private companies is 75,46 with deviation standard equal to 16,53, while commitment's average value from workers in the state owned companies is 67,37 with deviation standard equal to 18,33. Besides Zeffane, higher of commitment from workers in the private companies also proved by Buchanan's research in the year 1974, Rainey's research in the year 1979, Rainey Perry's research in the year 1988, Odom's research in the year 1990 and Savery's research in the year 1991 [10, 20]. Pursuant to this matter we can conclude that all worker in the private companies do not depend again at the transformational leadership to have collective perception about what is right based on ethics and how to handle the problem that related to ethics, because all worker have owned high commitment at values which have been specified. In the other word, all workers in the private company do not depend at charisma of the leader or support and motivation given by the leader to have collective perception about what is right based on ethics and how to handle the problem that related to ethics.

V. Conclusion

Ethical work climate being expected to give support for the company to achieve one of GCG principle/ dimension, i.e. social a awareness principle/dimension. This climate will give guidance for the workers to have perception about what is right based on ethics and how to handle the problem of which related to ethics (ethical behavior), so the workers can execute the culture and value of ethics in the corporate code of conduct eminently. To build the ethical work climate, the companies need the transformational leadership style. The companies will be more need the transformational leadership style if the workers in those companies have low commitment to the value which has been specified before.

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