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The Impact of Corporate Governance on Firm's Performance with Capital Structure as an Intervening Variable

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***Abstract*—This study aims to analyze the effect of corporate governance towards financial performance using return on assets (ROA) with capital structure (C) as an intervening variable in the manufacturing industry which were listed in Indonesia Stock Exchange (BEI) from 2012 to 2016. The number of final samples exercised were 68 entities with 340 observations and the multiple regression is opted for assessing the dependent and independent variables. Based on the models, there are two findings, where the first finding suggests that ownership concentration (OWNCON) and independent director (DIRIND) variables have negative effect towards Long-Term Debt (LTD) while board of director size (BSIZE) has positive impact on the LTD. Further, director ownership (DIROWN), business size (BSIZE), risk, and growth variables do not attest the correlation with LTD. The second finding manifests that LTD variable has negative impact on ROA, however, liquidity (LIQ) and AGE variables are positively correlated with ROA. The authors have the belief that by including more independent variables or secondary data in the future research will affect the research finding.**

Keywords—corporate governance; capital structure; firm performance

I. INTRODUCTION

A number of research in the effect of corporate governance on corporate performance have been continuously carried out. Taeyoung conducted a research in the South of Korea [1]. Their study manifested that inside ownership was positively correlated with ROA and audit committee member has negative correlation with ROA. Tarus, Ganguli, and Syeikh opined that ownership concentration has an effect on LTD [2-4]. Block holder has greater voting right to exert the management on optimizing debt to amplify the shareholders' wealth. In contrast, Anil demonstrated the negative correlation between OWNCON and LTD [5]. To a large degree, majority of shareholders inclined to make profits for. The use of debt will confine the majority shareholders' movements. This sort of practice happened frequently and it could become substantial issue, particularly in the countries where minority shareholders are less protected.

LTD was positively relevant to ROA [6]. Conflict of interest among the managers and shareholders frequently happen due to the fact that managers are inclined to increase their own profits than improve the shareholders' wealth. Issuing debts could dwindle the agency fee and change the performance of enterprise by means of empowering the managers to act on behalf of shareholders rather than their own interest [7-9]. Nevertheless, Dawar and Yazdanfar remarked that LTD has negative correlation with ROA, meanwhile increasing debt in LTD enabled to decrease the agency conflict between shareholders and managers, also it can reduce the flexibility of firm's cash flows in future which eventually exacerbate the company–risk of bankruptcy [9,10]. Simerly and Li [9] opined that debt has an effect on the firm's performance because it confines the firm to decision making.

II. METHOD

A. Data

This research exercises quantitative data from the secondary source, where manufacturing firms are listed in the Indonesian Stock Exchange (BEI) in the period of 2012 – 2016. The firms' financial reports are disclosed by end of the year, audited, having interest bearing debts in its capital structure. Also, the relevant variables are fully available.

B. Variables Definition

This study clusters two variables which are of two dependent (i.e. long-term debt and return on asset) and nine independent variables (i.e. ownership concentration, director ownership, independent director, board of director size, firm risk, growth, size, liquidity and firm age). Further, this research opts for two-stage least square from E-views 9.0 to run the quantitative analyses

C. Research Model

Based on the conceptual approach, this paper depicts the research model (see figure 1).

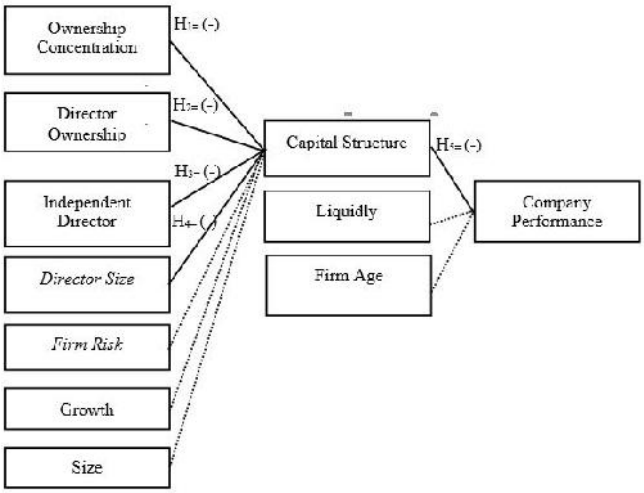

Fig. 1. Research model.

III. Result and Discussion

A. Analysis

TABLE I. First Stage Regression

Variable	Coefficient	Std. Error	t-Statistic
C	-0,156621	0,10292	-1,521778
OWNCON	-0,064363	0,02581	-2,4937**
DIROWN	-0,046751	0,072776	-0,642395
DIRIND	-0,063073	0,029511	-2,1372**
BSIZE	0,002919	0,02919	0,70663
RISK	-0,193245	0,219977	-0,878477
GROWTH	0,009861	0,01747	0,564483
SIZE	0,010061	0,00374	2,6902*
R-Squared	0,107745		
AdjustR-Squared	0,088932		
F-statistic	5,727262		
Prob(F-Statistic)	0,000003		
Observation	340		

Ownership concentration (OWNCON) has coefficient -0.064363 and correlation 0.0131. Meaning that OWNCON possesses negative correlation with LTD. This finding supports the study that Anil [5], conducted, however, it is not in line with the research result that was done by Tarus, Ganguli, and Sheikh [2,3,6] that demonstrated positive correlation between OWNCON and LTD. Using debt will confine the flexibility of majority shareholders. Nevertheless, debt remains required so that the assigned managers prioritize the interests of majority shareholders.

Director ownership (DIROWN) has coefficient -0.0468 and correlation 0.5211. Meaning that DIROWN has negative interdependence of LTD. The result manifests is similar to the research done by Wiwattanakantang [11], but is not identical to the researches' findings of Tarus and Syeikh that revealed positive correlation between DIROWN and LTD [2,4]. The larger portion of ownership of managers, the more similarity of interests both shareholders and management have in common with [11,12]. Managers will not make any decision that lead to depreciate the company's value. Therefore, debt funding is opted for reducing the unnecessary agencies issues. Hasan also opined that more debt composition might cause the firms deal with more default risk. The firms will take a loan whenever they need to fund the favorable projects [13].

Independent director (DIRIND) has coefficient -0.0631 and correlation 0.0333. Meaning that DIRIND is not significantly interdependence of LTD. This result is in-line with Dimitropoulos and Wenetal [14,15]. In contrast with research findings of Syeikh and Tarus who revealed the results of their studies where DIRIND was significantly and concurrently insignificantly correlated with LTD [2,6]. The reason for this was believed that the existence of independent commissioner towards board of directors would lead to using lower leverage due to the rigid supervision and control. Consequently, agency conflict between board of directors and shareholders can be mitigated [14,15]. In addition, the implementation of organizational management concepts such as independent board can become an influential instrument to govern the firms that is in virtue of principles of management; transparency, accountability and equity so that it can restrain the exposure of leverage [14].

Board of Director Size (BSIZE) has coefficient0.0021and correlation 0.4803. It means that BSIZE has positive correlation but not significantly correlated with LTD. This reveals similarity finding with the study of Tarus, Wenetal and Hussainey [2,15,16], but in contrast with the research finding of Syeikh that manifested positive correlation between director size and LTD [6]. Larger BSIZE might need more effective supervision, which would consequently lead to elevate the capital structure and companies' values. Mostly companies in Indonesia are owned by family businesses. Family business is consisted of members of family that majority hold the shares and strategic positions, where they participate in regulating the firms in order to attain better performance. Since the function of debt is treated as a mechanism to decrease the non-essential discretional management [15,16].

TABLE II. Second Stage Regression

Variable	Coefficient	Std.Error	t-Statistic
C	0,071541	0,029248	2,446013
LTDF	-0,594934	0,335484	-1,7733***
LIQ	0,012585	0,05528	2,2765**
AGE	0,000977	0,000364	2,6836
R-suared	0,045739		
Adjust R-squared	0,037219		
F-statistic	5,368312		
Prob(F-statistic)	0,001273		
Observation	340		

Source: Authors, 2017

Long-term Debt (LTD) has coefficient -0.5949and correlation 0.0771. This means that LTD has negative correlation with ROA. This result is associated with the research studies of Dawar and Yazdanfar [9,10], whereas our hypothesis affirms that there will be positive correlation between LTD and ROA. This means that there is statistical error in the first stage. Meanwhile, the incremental of debt in capital structure decreases the agency conflicts between shareholders and managers, and escalation of debt can decrease the flexibility of cash flow in the future that leads to the escalation of risk of bankruptcy. Dawar remarked that debt has a negative effect on the performance as it confines the firms to make decisions [9].

B. Hypotheses

Tarus defined that Ownership Concentration (OWNCON) is the percentage of stocks that are held by 10 largest shareholders [2]. Anil viewed the negative link between OWNCON and leverage. The largest shareholders will strive to obtain profits for themselves [5]. Exercising debt will hinder the activity of majority shareholders. Right of possession by blockholder is likely to shrink the conflict of interest among managers and shareholders. Blockholder has larger control than common shareholder to affect the managerial decision making.

H1: Ownership Concentration has negative correlation with capital structure.

Director ownership (DIROWN) is possession of equity by director and in this case is the commissioner. The larger ratio of ownership of managers have, the more linear would be the interest of shareholders and management [11,12]. Manager will not make a decision that depreciates the company's. Hence, debt financing as an instrument to lessen the agency problem is not necessary. Likewise, Dimitropoulos [14] viewed that the greater debt ratio of a firm has, the greater will be its default risk. Using debt constrained managers to obtain more perks and this would make the company more efficient in reducing the possibility of getting bankrupt and losing control [4,7].

H2: Director ownership (DIROWN) has negative correlation with capital structure.

Independent director (DIRIND) is the percentage of DIRIND in the board of directors, which is also called commissioner. Managers would exercise less debt in the case of vigorous management. Independent commissioner on the board will lead to lower use of leverage ascribed to rigid monitor and control so that the agency conflicts between directors and shareholders can be curtailed [14,15]. The existence of independent director escalates the protection of common shareholders through improving the effectiveness of decision making and supervising the executives.

H3: Independent Director has negative correlation with capital structure.

Board of Director Size is the number of firm's directors-that is commissioners larger board of director size requires more effective supervision that eventually increases the leverage in the company's value [8,15]. The large board of director size will affect the process of making decision which has an effect on the quality management. Therefore, using debt is likely to be taken as a means to reduce the conflicts of interest between agents and shareholders by dwindling the agency costs from free cash flows available to managers [14].

H4: Board of Director size has positive correlation with capital structure.

Long-term Debt (LTD) is defined as total long-term debt over total asset. Conflict of interests between managers and shareholders appear due to the fact that managers are likely to increase their own wealth instead of increasing the wealth of shareholders. Issuing debt can reduce agency cost and affect the firm's performance by encouraging the managers to act on behalf of the shareholders' interests rather than their own interests [7-9].

H5: Long term debt has positive correlation with ROA.

IV. CONCLUSION

Under the hypothetical test using t-test, this research presents that independent variables ownership concentration, number of independent directors, and board of director size are significantly interrelated with LTD, and AGE has positive correlation with ROA. While, LTD is slightly correlated but it tends to be not correlated with ROA and LIQ has slightly negative relation with ROA but, to a large extent, it tends to be correlated with ROA.

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