The effect of good corporate governance on capital structure in financial sector firms listed on the Indonesia stock exchange over the period of 2012-2016

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ABSTRACT: The purpose of this study is to examine the effect of board size, managerial ownership, institutional investors, profitability, size, and growth as the independent variables on the capital structure of all non-financial companies listed on the Indonesia Stock Exchange. This study used a quantitative perspective with linear regression and panel data models with a number of research observations of 1,625, consisting of 325 companies listed on the Indonesia Stock Exchange over the period of 2012-2016. The results of the study prove that managerial ownership, profitability, and size had a significant negative effect on capital structure. Whereas growth had a significant positive effect on the capital structure and board size and institutional investors had no significant effect on capital structure (debt ratio).

Keywords: managerial ownership, institutional investor, capital structure

1. INTRODUCTION

Along with the times, companies are increasingly competitive in global competition. This is examined by the freedom of local and foreign companies to trade in other countries. This condition makes local companies have to set a good performance. To carry out a good performance, the firm needs to focus on managing the firm to the fullest. Macroeconomic conditions in Indonesia are vulnerable to the economic crisis which has resulted in rising interest rates. If interest rates increase, the burden that must be borne by the company is greater because of the increase in the cost of debt and the cost of equity. Research on capital structure is important so that companies can increase returns and minimize company costs optimally. If the company is wrong in applying the capital structure, then the company's costs will be even greater. Increasing costs make the company must fund the excess expenditure which increases the company's burden.

Dimitropoulos (2014) conducted research on the capital structure and governance of European football clubs. This study used the debt ratio as the dependent variable. The results found in this study were managerial ownership, institutional investors, CEO duality, CEO tenure, intangible assets, and size have a significant positive effect on the debt ratio; then board independence, board size, and profitability have a significant negative effect on the debt ratio; and audit type and growth has no significant negative effect on the debt ratio. Sheikh & Wang (2012) conducted a study of the effects of governance on capital structures based on empirical evidence in Pakistan. The dependent variable used was the debt ratio. The results of the research found were board size, outside director, ownership concentration, and size have a positive significant effect on the debt ratio; then director remuneration, profitability, liquidity, and asset tangibility have a significant negative effect on the debt ratio; and managerial ownership and CEO duality have a negative but not significant effect on the debt ratio. Hussainey & Aljifri (2012) examined the mechanisms of governance and capital structure in the United Arab Emirates. The research used the debt ratio as the dependent variable. The results of the study were size has a significant positive effect on the debt ratio; institu-

tional investors and payout dividends have a significant negative effect on the debt ratio; then growth has a positive but not significant effect on the debt ratio; and board size, governmental ownership, audit type, governmental ownership, and profitability have a negative but not significant effect on the debt ratio.

In the research conducted by Dimitropoulos (2014), the board size has a negative influence on the debt ratio, meaning the larger the board size, the less the use of debt in the company. According to the argument of Goodstein et al. (1994), Psaros (2009) & Reddy et al. (2010) in Dimitropoulos (2014), the board of commissioners who have high positions provide increased expertise, greater monitoring, and access to a broader range of contracts and resources. This makes the company have a more efficient and trusted performance by stakeholders because it is able to increase resources to use creditors as supervisors. Therefore, companies do not need to be too dependent on debt.

H1: Board Size has a negative effect on capital structure

In the study conducted by Dimitropoulos (2014), managerial ownership has a positive effect on the debt ratio. This means that the higher the level of managerial ownership, the higher the use of debt in the company. Jensen & Meckling (1976) in Dimitropoulos (2014) argue that increasing managerial ownership can reduce agency conflict between managers and shareholders because managers and shareholders have equal interests. This is in line with the pecking order theory that states higher managerial ownership makes the company has confidence in the company's ability, thereby encourages companies to use debt.

H2: Managerial ownership has a positive effect on capital structure

Institutional investors have a positive influence on the debt ratio where the higher institutional investor makes companies use larger debt. Dimitropoulos (2014) state that institutional investors improve the efficiency of corporate governance by conducting external supervision that can reduce agency costs. Dimitropoulos (2014) argues if institutional investors have high ownership shares, institutional investors will ask for a strong organizational structure to protect their investment. In agency theory, one way to reduce conflict is that institutional investors act as corporate supervisors. If an institutional investor becomes a supervisor, then the manager cannot increase the company's debt as much as possible and will only use debt as much as the optimal proportion for the company.

H3: Institutional Investors have a positive effect on capital structure

In the study conducted by Dimitropoulos (2014) and Sheikh & Wang (2012), profitability has a negative effect on the debt ratio which means the greater the profitability of the company, the lower the debt used. Companies that have high profitability tend to use retained earnings as a source of funding. This is in accordance with the pecking order theory that the greater the profitability, the more profit the company earns, so the company does not need to use debt. If internal funds are sufficient, the company does not need to borrow funds from external sources.

H4: Profitability has a negative effect on capital structure

In the study conducted by Dimitropoulos (2014), Sheikh & Wang (2012) and Hussainey & Aljifri (2012), size has a positive influence on the debt ratio because the greater the number of assets owned by the company, the lender will be willing to give a loan in the large amount to the company, because large assets can be used as collateral for the use of debt. Dimitropoulos (2014) argue that large size companies have quality projects in their portfolios where the company funds the project by using bank debt to avoid spreading information to competitors. Large size companies are daring to take high risks where companies tend to issue debt compared to equity.

H5: Size has a positive effect on capital structure

According to Dimitropoulos (2014), growth is the percentage change in income growth that occurs every year. The number of assets owned by the company is the size of the company. Dimitropoulos (2014) say that growth has a positive effect on the debt ratio. The higher the growth rate, the higher the use of debt, because the company needs to finance various future projects, so the company needs to make loans.

H6: Growth has a positive effect on capital structure

2 RESEARCH METHODS

The research is basic research where this research examines a study that has been done previously with quantitative data. This research type is causal research because it aims to prove the influence of board size, managerial ownership, institutional investors, profitability, size, and growth on the debt ratio of non-financial sector companies listed on the Indonesia Stock Exchange over the period of 2012-2016.

The population of this study was all non-financial sector companies listed on the Indonesia Stock Exchange (IDX) over the period of 2012-2016 with the following criteria: (1) the companies were registered in the non-financial sector for 5 consecutive years, (2) the companies always issued audited annual reports in 5 consecutive years, and (3) the companies had all variable needed over in the financial statement for the period of 2012-2016.

The equation used in this study is:

$$DRi, = \propto + \beta_1 BDSIZEi, + \beta_2 MOWNi,t + \beta_3 IOWNi,t + \beta_4 PROFi,t + \beta_5 SIZEi,t + \beta_6 GROWTH + e_{i,t}$$

3 RESULTS AND DISCUSSIONS

The regression equation in table 1 shows the debt ratio as the dependent variable. The independent variables are board size, managerial ownership, and institutional investors. While the control variables are profitability, size, and growth.

Table 1. The Results of Regression

Variables	B	t	Sig.
BDSIZE	-0.00254	-1.39304	0.1638
MOWN	-0.09595	-3.00890	0.0027***
IOWN	-0.02141	-1.30148	0.1933
PROF	-0.38287	-9.87873	0.0000***
SIZE	-0.12811	-5.37754	0.0000***
GROWTH	0.01294	1.99905	0.0458**
R Squared		0.96340	
Adjusted R Squared		0.95407	
F Statistics		103.2309	
Prob. F Stat.		0.0000	

Note ** : significance at 5%
*** : significance at 1%

Board size has a negative but insignificant effect on the debt ratio. This is supported by Hussainey & Aljifri (2012), Thesarani (2017), Wardhani (2007), and Mariana (2016) but contrary to Dimitropoulos (2014) who found a significant negative relationship between board size and debt ratio. Thesarani (2017) states that the board of commissioners is less effective in supervising and controlling the operations of the company. The large size of the board of commissioners makes it more difficult for them to communicate, coordinate, and make decisions that must be mutually agreed (Wardhani (2007)). In addition, many boards of commissioners in a company also serve as a board of commissioners or board of directors in other companies with a number that is not small, so this will affect the time allocation of each company (Mariana (2016)). Therefore, the size of the board of commissioners had no effect on the debt ratio.

Managerial ownership has a significant negative effect on the debt ratio. This is supported by Christiawan & Tarigan (2007), but contrary to Dimitropoulos (2014) who found a significant positive relationship between managerial ownership and the debt ratio. The results of the study show a significant negative effect which means there is an effect but the direction is contrary to the hypothesis. This condition indicates a type 1 error. Type 1 error occurs when the results of the study state that H0 is rejected, but actually H0 is correct (table 2). Christiawan & Tarigan (2007) state that managerial ownership has two roles in the company, namely as managers and shareholders. As a manager and shareholder, managerial ownership does not want the company to experience financial difficulties or even bankruptcy, because financial difficulties or bankruptcy will harm him either manager or shareholder. As a manager, he will lose incentives and as a shareholder, will lose return even the funds invested. Therefore, managerial ownership prefers to look safe by reducing the level of corporate debt (Christiawan & Tarigan (2007)). The higher the level of debt, the higher the company carries the risk of bankruptcy due to financial distress.

Institutional investors have a non-significant negative effect on the debt ratio. This result is contrary to Dimitropoulos (2014) who found investor institutions and debt ratios had a significant negative effect. On the other hand, this result is supported by Nurmasari (2015) and Manzaneque et al. (2016) who found institutional investors had a non-significant negative relationship to the debt ratio. Nurmasari (2015) states that investor institutions are still not effective in monitoring all decisions taken by company management. As it is not yet effective, institutional investors do not have sufficient ability to provide input to management (Manzaneque et al. (2016)). Institutional investors do not directly influence managerial decisions so they cannot influence the debt ratio condition.

Profitability has a significant negative effect on the debt ratio. These results are supported by Dimitropoulos (2014) and Sheikh & Wang (2012), but are contrary to Hussainey & Aljifri (2012) who found profitability and debt ratios do not influence each other. Dimitropoulos (2014) and Sheikh & Wang (2012) state that companies that have high profitability tend to use retained earnings as a source of funding, so companies choose to use internal funding. Companies that have large net income and debt will not affect the capital structure, because companies have the ability to pay high-interest rates. A high

rate of return allows the company to pay most of its funding needs with funds generated internally.

Size has a significant negative effect on the debt ratio. This is contrary to Dimitropoulos (2014), Sheikh & Wang (2012), and Hussainey & Aljifri (2012) who found a significant positive relationship between size and debt ratio. The results of the study show a significant negative which means there is an influence but the direction is contrary to the hypothesis. This condition indicates a type 1 error. Type 1 error occurs when the results of the research state that H0 is rejected, but actually H0 is correct (table 2). The larger size of the company makes the company able to manage the risk of refinancing well, so the company makes its funding decisions through internal funding. Therefore, companies do not need to consider external funding as a funding option.

Growth has a significant positive effect on the debt ratio. This is supported by Murhadi (2011), but contrary to Dimitropoulos (2014) who point out a significant negative relationship between growth and debt ratio.

4. CONCLUSION

The first hypothesis which states board size has a negative effect on a firm's debt ratio was not proven. The researchers found that the board size had no effect on the debt ratio. The second hypothesis that assumes managerial ownership has a positive effect on a company's debt ratio was not proven. The researchers found that managerial ownership had a negative effect on the debt ratio. The third hypothesis that says institutional investors have an effect on the debt ratio was not proven. The researchers found that institutional investors did not influence the debt ratio. The fourth hypothesis that predicts profitability has a negative effect on the debt ratio was proven. The fifth hypothesis that assumes size has a positive effect on the debt ratio t was not proven. The researchers found the size had a negative effect on the debt ratio. The sixth hypothesis that proposes growth has a positive effect on the debt ratio was not proven. The researchers found growth had a positive effect on the debt ratio. Based on the results of testing the hypothesis by conducting a t test, it can be concluded that managerial ownership, profitability, and size had a significant negative effect on the debt ratio. Meanwhile, growth had a significant positive effect on the debt ratio. For board size and institutional investors had a not significant negative effect on the debt ratio. Then, the test results found the adjusted-R2 value is 95.41% which proves that board size, managerial ownership, institutional investors, profitability, size, and growth are able to explain the debt ratio very well.

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