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Influence of Corporate Governance on Capital Structure Decision: Evidence From Indonesian Capital Market

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This study investigated the influence of corporate governance on capital structure decision in Indonesian companies. The population in this research included all companies which were listed in Indonesian Stock Exchange (IDX) for the years of 2007-2009, but excluded banking companies and other financial institutions. All 92 companies in the population were studied. Multiple linear regression method was used to investigate the influence of corporate governance mechanisms – namely board of directors size, board of commissaries composition, family governance, managerial ownership and institutional ownership – on capital structure decision (debt-to-equity ratio). The results of the hypothetical testing show that board of directors size and board of commissaries composition have negative influences on capital structure decision. The other corporate governance variables are shown to have no significant influence on capital structure decision. Analytical results on the influence of the control variables on capital structure decision are in agreement with the theories and literatures of capital structure.

Field of Research: Corporate governance mechanisms, capital structure decision, Indonesian companies.

1. Introduction

The term corporate governance was first introduced by Cadbury Committee in 1992. Corporate governance is essential because it has been empirically proven that investors are willing to give relatively high premium on companies that apply the principle of corporate governance in a good and consistent manner (Lukuhay 2002; Rafick 2002). Agency relationship perspective is the underlying theory to understand corporate governance (Darmawati, 2004). In agency theory, agency relationship emerges when one or more principals employ an agent for a service and then delegate the authority of decision making to that agent (Jensen and Meckling 1976). Manager as an agent has the responsibility of maximizing the welfare of the shareholders by gaining as high profit as possible. Manager also has his own interest and is the one who understands the most about the internal condition of a company.

Attempts to unify the interests of these parties often give rise to agency conflict. Differences of interest arise from the fact that each party is opportunistic, such that decision making and implementation is mostly determined by the corporate governance mechanisms in that particular company. Any decisions, either financial or non-financial, made by the management of a company will affect the performance of the company, which in turn will affect the shareholder’s trust (Abor 2007; Berger et al. 1997; Friend & Lang 1998).

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One important financial decision in relation to the operation of a company is the decision on capital structure (Glen & Pinto 1994; Wen et al. 2002; Abor & Bikpie 2005; Abor & Bikpie 2007), which is a financial decision related to debt composition, preferred stock and common stock that should be adopted by a business organization. Determination of capital structure decision will influence the operational scope of a company and therefore, optimal choice of capital structure is required. An optimal capital structure is one that is able to maximize the value of a company as well as to provide profits to the stockholders and staffs. Capital structure decision is important because it influences not only the return but also the financial risk faced by the company (Abor & Bikpie 2005).

Indonesia is a developing country with many growing companies. Information of the influences of corporate governance variables on capital structure decision in companies in Indonesia will provide a reference in making investment decisions for the investors. Furthermore, the information will also fulfill the needs of the creditors to know the financial condition and performance of a particular company. Internal management can also use the information to strengthen the company financial performance.

Various studies have been conducted to investigate the influences of corporate governance variables on capital structure decision (Jensen 1986; Kim & Sorensen 1986; Mehran 1992; Bathala *et al*. 1994;Berger *et al.* 1997; Friend & Lang 1998; McConaughy 1999; Wiwattanakantang 1999; Wen *et al*. 2002; Anderson & Reeb 2003;Abor & Bikpie 2005; Abor 2007; Ellul 2008; Hussainey & Al-Nodel 2009; Al-Najjar & Hussaeny 2009a, 2009b; Hussainey & Al-Nodel 2009; Hasan & Butt 2009), but different results were reported. The inconsistency of the previous studies means an investigation of corporate governance variables in Indonesia is necessary. There have been limited studies that addressed the influence of corporate governance on capital structure decision in Southeast Asia, especially in Indonesia. Therefore, it is essential to study the influence of corporate governance on the capital structure decision of companies which are listed in Indonesian Stock Exchange (IDX).

In this study, only five variables of corporate governance namely board of directors size, board of commissaries composition, family governance, managerial ownership and institutional ownership were investigated because these five variables are listed in two-tier system in Indonesia. The data of these five variables are available from the financial reports of the companies and there are some disagreements from previous studies of their influence to capital structure decision which make them interesting to be studied for Indonesian companies.

Comprehensive literature review of corporate governance and the influence of its variables to capital structure decision are presented in Section 2. Section 3 presents the research methodology used in this study and Section 4 discusses the result and its significances. Finally, Section 5 concludes this study by emphasizing the key findings and suggesting area of future research.

2. Literature Review

Cadbury Committee described the corporate governance system as “the system by which companies are directed and controlled” (Cadburry 1992). Directing here means to shape the strategic direction of a company in the future, to get involved in decisions which are naturally difficult to achieve, to get involved in allocation or reallocation of important financial resources (such as decisions on large investments) and other resources (such as election of CEO in human resources), and to get involved in decisions which are precedent-based and/or difficult to turn around. In short, directing means to get involved in strategic decisions. Controlling in corporate governance means to supervise the management performance and to monitor the progress of the targets of the company.

According to Shapiro and Balbirer (2000), “Capital structure is the combination of debt and equity financing used by company to finance the purchase of its asset.” Thus, the concept of capital structure can be considered to be one that discusses the composition with which a company is financed, either by own or loan capital. If a company can fulfill most of the fund or capital needs internally, dependence on external parties will be reduced.

Corporate governance has been identified in previous studies as one contributing factor to capital structure decision which will have an impact on the financial condition and performance of a company (Berger et al. 1997; Friend & Lang 1998). Previous studies have provided an evidence that corporate governance mechanisms influence capital structure decision (Jensen 1986; Kim & Sorensen 1986; Mehran 1992; Bathala *et al*. 1994;Berger *et al.* 1997; Friend & Lang 1998; McConaughy 1999;Wiwattanakantang 1999; Wen *et al*. 2002; Anderson & Reeb 2003;Abor & Bikpie 2005; Abor 2007; Ellul 2008; Hussainey & Al-Nodel 2009; Al-Najjar & Hussaeny 2009a, 2009b; Hussainey & Al-Nodel 2009; Hasan & Butt 2009). Various corporate governance mechanisms which influence the capital structure decision of a company, for example board size, board of commissaries composition, board of directors composition, CEO duality, board skill, board tenure, family governance, managerial ownership and institutional ownership have been investigated. Problem often encountered in this ownership structures is the agency conflict between the management as decision maker and the stockholders as owner of the company. These conflicting interests will certainly influence the decision making.

Studies from Mehran (1992), Berger et al. (1997), Abor & Biekpe (2005) and Hassan and Butt (2009) showed a negative influence of board of directors size on debt to equity ratio (DER) as a measure of capital structure. In contrast, Jensen (1986) and Hussainey and Al-Nodel (2009) found that board of directors size has a positive influence on DER so that the larger the board of directors size the higher the leverage level. Other studies (Wiwattanakantang 1999; Wen *et al*. 2002; Al-Najjar & Hussainey 2009a; Al-Najjar & Hussainey 2009b) found that there is no significant influence of the board of directors size on DER.

Wiwattanakantang (1999), Jensen (1986), Bathala *et al*. (1994), Berger *et al*. (1997) and Abor (2007) found that independent commissaries have a positive influence on the company leverage. Al-Najjar & Hussainey (2009a) and Wen et al. (2002) discovered that independent commissaries have a significant negative influence on DER. Independent commissaries tend to monitor the managers actively, which causes the latter to choose lower leverage to increase performance. Al-Najjar & Hussainey (2009b) found that independent commissaries have no influence on leverage level.

Family governance variable is family relationship in different functions, i.e. decision maker and decision supervisor or monitoring. According to Ellul (2008), a company which is led by family members can potentially cause an overlapping function between decision maker and decision supervisor. More dominant family members will influence the function of other family members. In this case, monitoring role from the commissaries becomes loose due to this family relationship. Mishra and McConaughy (1999) in the US found that companies with family relationships in the management board and commisary board negatively influence the leverage. However, Anderson and Reeb (2003) found that companies in the US with family relationships in the management board and commisary board do not influence the capital structure. In contrast, Ellul (2008) found that companies with family relationships in the management board and commisary board positively influence the capital structure.

Bathala et al. (1994) investigated the influence of institutional ownership on DER. Their results showed that institutional ownership has a negative influence on DER. Friend and Lang (1988), showed that managerial ownership has a negative influence on DER. Kim and Sorensen (1986), and Mehran (1992) studied the influence of managerial ownership on debt ratio and they found a positive influence on leverage ratio. However, Jensen et al. (1992) claimed that there is a negative influence of the percentage of ownership by managers on DER.

All the studies reviewed here were done in different regions and their results are inconsistent. Studies that investigate the influence of corporate governance mechanism in Indonesia are limited while corporate governance characteristic in every country is different depending on the culture which shapes the corporate governance mechanism. Thus it is necessary to conduct a study on the influence of corporate governance influence on capital structure decision in Indonesia.

3. Research Methodology

This study excludes banking companies and other financial institutions to avoid inaccuracy in data analysis due to different classification of accounts in their financial reports and to avoid any influence of government regulation that subjects banks and other financial institutions to certain restrictions or requirements. Target population of this study are all go public companies that are listed in IDX for the years of 2007-2009. The selection of the target population are based on the fact that go public companies listed in IDX have complete data compared to non-listed companies.

Population characteristics used in this study are:

1. Does not fall in the category of a banking company or other financial institution.
2. Has complete financial reports for the period of 2007-2009, which are provided in rupiahs and have been audited (no disclaimer in the financial report).
3. Is not in insolvent financial condition (does not have negative equity)
4. Has a complete corporate governance data which are needed in this research namely board of directors size, board of commissaries composition, family governance, managerial ownership and institutional ownership. This is shown by:
   a. Including the list of the board of directors members in its notes to financial statement.
   b. Including the list of the board of commissaries member and stating any independent commisary in its notes to financial statement.
   c. Including the list of share capital ownership in its notes to financial statement.

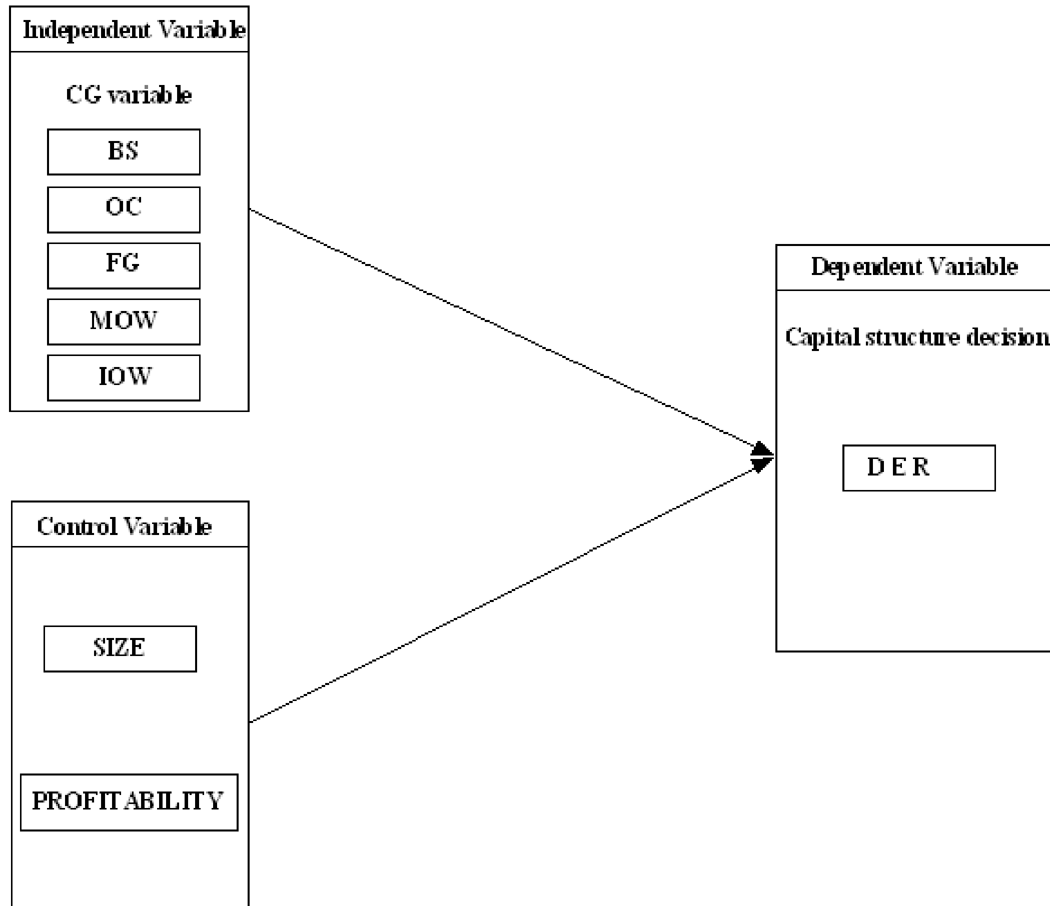
There are 92 go-public companies listed in IDX with suitable characteristics and this study was done by examining the data obtained from the financial reports of all those 92 companies.

This study used multiple linear regression method to investigate the influence of five variables of corporate governance, i.e. board of directors size (BS), board of commissaries composition (BC), family governance (FG), managerial ownership (MOW), institutional ownership (IOW) and control variables (company size (SIZE) and profitability (PRFT)) on the leverage level or DER, i.e. total debt divided by total equity, as capital structure decision variable.

From the many variables of corporate governance which have been investigated, there are several variables which cannot be used in Indonesia because Indonesia adopts a two-tier system, i.e. CEO duality and external directors composition. Other than that, there are variables which cannot be easily investigated due to inavailability of data such as board skill or directors' expertise-to-position compatibility, serving term of the board of directors and salary of directors.

Based on literature review and previous studies, the research framework of this study is as illustrated in Figure 1.

Figure 1: Research framework to investigate corporate governance variables influence to DER



The Research Model is:

$$DER_{it} = \beta_0 + \beta_1 BS_{i,t} + \beta_2 BC_{i,t} + \beta_3 FG_{i,t} + \beta_4 MOW_{i,t} + \beta_5 IOW_{i,t} + \beta_6 SIZE_{i,t} + \beta_9 PRFT_{i,t} + \varepsilon$$

BS was measured with natural logarithm of amount of directors. BC was measured by calculating the proportion of independent commissaries with respect to the total commissaries. FG was measured with a dummy variable, which is assigned to 1 if there is family governance in the board of commissaries and board of directors, and 0 otherwise. MOW was measured from the proportion of managerial ownership with respect to the total stocks. IOW is the proportion of institutional ownership from external parties with respect to the total stocks. This study used two control variables, namely company size (SIZE) and profitability (PRFT). Company size was measured with log N total asset. Profitability was measured by using the ratio of EBIT (earning before interest and tax) to total asset.

In the previous studies, capital structure decision was defined as debt to asset ratio, long term DER, or short term DER. In this study, however, capital structure decision was defined as the leverage level and the capital structure is measured from total DER

because DER directly shows the proportion of total debt to total shareholder's equity. Besides, total DER was used because in Indonesia, long term debt and short term debt have equal proportion.

4. Discussion of Empirical Result

Table 1: Descriptive Statistics Summary

Variable	Min	Max	Mean	Std. Dev.
DER	0.01	3.64	1.11	0.72
BS	0.69	2.30	1.52	0.37
BC	0.04	0.70	0.38	0.11
FG	0.00	1.00	0.36	0.48
MOW	0.00	25.40	1.52	4.14
IOW	12.93	99.99	69.75	18.40
SIZE	24.20	32.21	28.01	1.58
PRFT	-0.61	0.61	0.09	0.12

Table 1 provides a summary of the descriptive statistics of the dependent and independent variables. It shows the average indicators of variables used. The mean DER of the firms is 1.11. Board of directors size, determined as the natural logarithm of amount of directors, has a mean of 1.52. The average proportion of independent commissaries is 38%. Average family governance is 0.36. Average managerial ownership is 1.52. Average institutional ownership is 69.75. Firm size, determined as the natural logarithm of total assets has a mean 28.01. Profitability, given as the ratio of EBIT to total assets, registers a mean value of 0.09 suggesting a return on assets of 9%.

From Table 2, the following linear regression equation was obtained:

$$DER_{it} = -2.715 - 0.380\, BS_{i,t} - 1.010\, BC_{i,t} - 0.102\, FG_{i,t} + 0.001\, MOW_{i,t} + 0.001\, IOW_{i,t} + 0.176\, SIZE_{i,t} - 1.716\, PRFT_{i,t} + \varepsilon$$

Table 2: Model Result

Model	Value	Sig	Relationship	Influence
(Constant)	-2.715	0.003		
BS	-0.380	0.014	negative	Significant
BC	-1.010	0.008	negative	Significant
FG	-0.102	0.246	negative	No
MOW	0.001	0.892	positive	No
IOW	0.001	0.816	positive	No
SIZE	0.176	0.000	positive	Significant
PRFT	-1.716	0.000	negative	Significant

Figure 2: SPSS Output

Model Summary (b)

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Change Statistics					Durbin-Watson
					R Square Change	F Change	df1	df2	Sig. F Change	
1	.425(a)	.181	.159	.65891	.181	8.450	7	268	.000	1.926

a Predictors: (Constant), PRFT, BC, FG, IOW, MOW, SIZE, BS
b Dependent Variable: DER

Anova (b)

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	25.681	7	3.669	8.450	.000(a)
	Residual	116.354	268	.434		
	Total	142.035	275			

a Predictors: (Constant), PRFT, BC, FG, IOW, MOW, SIZE, BS
b Dependent Variable: DER

Coefficients (a)

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.	Collinearity Statistics	
		B	Std. Error	Beta	Zero-order	Partial	Tolerance	VIF
1	(Constant)	-2.715	.910		-2.984	.003		
	BS	-.380	.154	-.195	-2.468	.014	.491	2.035
	BC	-1.010	.377	-.152	-2.679	.008	.948	1.055
	FG	-.102	.088	-.068	-1.162	.246	.889	1.125
	MOW	.001	.010	.008	.136	.892	.929	1.076
	IOW	.001	.002	.014	.233	.816	.873	1.146
	SIZE	.176	.035	.386	5.025	.000	.517	1.935
	PRFT	-1.716	.357	-.292	-4.809	.000	.829	1.206

a Dependent Variable: DER

Regression analysis is used to investigate the significant relationship between variable of corporate governance and capital structure decision. The ordinary least squares (OLS) panel was found to be the most robust after testing for various options of the panel data regression such as Fixed Effects and Random Effects. The OLS regression results are presented in Table 2. The results from the regression model denote that the independent variables explain the DER determination of the firms at 18.8% as can be seen in Figure 2. The F-statistics prove the validity of the estimated models. The results indicate that there are statistically significant relationships in the case of BS and BC. BS has negative influence on capital structure decision. BC has negative influence on capital structure decision with alpha 5%. FG, MOW and IOW have no significant influence on capital structure decision. Analytical results on the control variables are in agreement with the theories and literatures of capital structure.

The significantly negative relationship between board of directors size and capital structure decision suggests that larger boards adopt low debt policy. Board of directors is a governance variable with highest authority in the decision making of a company. The board of directors is in charge of managing the company and its operation. This finding provides an empirical proof that large amount of directors will be able to pressurize the management to improve their performance by using a small amount of loan. Logically, many directors may give rise to difficulties in reaching an agreement in decision making. Conflict in the case of many directors causes it to be more difficult to make decisions on high external funding (debt) because of risk consideration as compared to the case of fewer directors. This finding also shows that the characteristics of the board of directors in Indonesia are cautious and conservative as well as tending to be less speculative for short-term interest. This result is in agreement with the results from Mehran (1992), Berger *et al*. (1997), Abor and Biekpe (2005) and Hassan and Butt (2009).

Second finding of this study shows that board of commissaries composition has a significantly negative influence on capital structure decision. This result is in agreement with Al-Najjar & Hussainey (2009a) and Wen et al. (2002). This finding indicates that the more the number of independent commissaries in a company, then the less the funding from external parties (debt). This condition indicates that a company with more independent commissaries will have a better monitoring level so as to minimize the likelihood of high debt. Independent commissaries serve to directly supervise any sub-optimal decisions by the managers, such as decision on company funding resources. From this study, it can be seen that the supervisory level from independent commissaries regarding debt usage is significant. Independent commissaries tend to monitor the managers actively, so that managers choose lower leverage to improve performance. This result shows that independent commissary is the best position to conduct the function of monitoring. These independent commissaries act as effective supervisory agencies because they are able to control opportunistic behavior of managers and at the same time to allow the company to manage the debt level optimally. The larger the proportion of independent commissaries with respect to total number of commissaries, the tighter the control of debt usage in funding the operation of a company. With supervision from independent commissaries, managers and agencies will be more careful and transparent in deciding the source of funding and thus, reduce the tendency to generate external fund (debt).

Insignificant negative relationship between family governance and capital structure decision can be explained by the fact that the proportion of total family membership with respect to the total amount of directors or commissaries is not large so that they have less influence in the decision making of a company.

Insignificant positive relationship between managerial ownership and DER can be explained by the harmony between entrenchment effect and managerial ownership, as elaborated by Jensen and Meckling (1976) and Fama and Jensen (1983). Specifically, if stocks owned by managers are low, increase in managerial ownership has an impact on the harmony of interest between management and stockholders. As managerial ownership increases from low level, manager is not urged to reduce the debt level,

resulting in higher debt level (positive relationship). However, when managers hold a significant proportion of the stocks (high percentage of managerial ownership), entrenchment effect is formed, resulting in higher opportunism of managers and hence, lower debt ratio (negative relationship). Specifically, voting power and significant influence make it harder to control opportunistic behavior of managers.

Insignificant positive relationship between institutional ownership and DER can be explained by Pound (1988) which stated that a high stockholder (high institutional ownership level) could be a passive voter who cooperates with corporate insider to oppose the interest of dispersed shareholder. Another concept to explain this is the lack of transparency principles, i.e. equality in conveying information. Logically, institutional stockholder is unaware of the company internal condition other than the information provided by the management. Institutional investors with lack of access to the company internal information will not be able to conduct a thorough analysis and tend to delegate the capital structure decision to those of better knowledge about the company condition (managers).

The analysis result shows that company size has a significantly positive influence on the capital structure decision, which is in agreement with the theory. A company with a large asset has a capability to fulfill its liability. The analysis result also shows that profitability has a significantly negative influence on the capital structure decision. A company with a high profitability tends to rely on its own financial source and thus automatically reduces its debts.

One can use the analysis above as the basis to make decisions based on individual preference or interest. For investors, important points are:

1. The larger the board of directors size of a company, the lower the debt compared to the equity. Based on the basic principal of economy ”high risk, high return”, investor who is expecting high profit and willing to take high risk should put his money into a company with a small board of directors size. On the other hand, investor who does not like to take the risk should put his money into a company with a large board of directors size.
2. The larger the proportion of independent commisaries in board of commissaries of a company, the lower the debt compared to the equity. This fact shows that independent commisaires have a significant role in monitoring the source of funding of a company. Based on this result, investor should put his money into a company with a large proportion of independent commisaries.
3. The larger the asset means the larger the capacity of the company to pay its debt. An investor who wants his money to be safe and profitable should put his money to a company with a large asset.
4. A company with a high profitability automatically attracts investors. In addition, based on the analysis above, a company with a high profitability tend to reduce its debts and thus lowering the risk for the investors.
5. Based on the analysis above, investors need not consider family relationship in the decision maker and monitoring position because it has been proven that they do not have significant influence to the leverage level.

For creditors, important points are:

1. Board of directors size has negative influence to the debts. Creditors might still decide to give credits to a company with a small board of directors but the capability of the company to return the credits must be carefully examined.
2. Proportion of independent commisaries has negative influence to the debts. Creditors might still decide to give credits to a company with a small proportion of independent commisaries because it tends to use large external funds, but the capability of the company to return the credits must be carefully examined.
3. For the creditors, it is recommended to improve the monitoring function to the company management especially for small companies because from this study, it was found that the company size has a negative influence to the debts. This shows that generally a small company has a high debt ratio because it does not have sufficient internal funds to cover its investment cost. A small company does not have a very large asset and thus has a higher risk to face bankruptcy. Thus monitoring function to the company management is necessary for the company to be able to return the credits.
4. Profitability of a company will automatically attract the creditors to give credits to that company. Although based on this study a company with a high profitability tends to lower its debts, a high profitability will lower the risk of unpaid debts.
5. Based on the analysis above, creditors need not consider family relationship in the decision maker and monitoring position because it has been proven that they do not have significant influence to the leverage level.
6. Creditors must keep monitoring if a company adopts a high debt policy. It is recommended to protect the creditors with contracts when giving credits to ensure the company to fulfill its liability, for example by giving a higher interest rate. A tight monitoring will ensure the manager to act according to the interests of debtholders and shareholders.

For internal users, it is important to remember that the higher the DER, the larger a company liability to external source. This causes the company to be more dependent on external source. Based on the above analysis, the company management, which is a representative of the internal users, does not need to avoid family positioning in the decision maker or monitoring positions. However, in the case of management ownership, management should increase the number of independent commissaries and board of directors member to lower the debt level in order to minimize the financial risk or the company and the risk of losing the capital.

5. Conclusion

We have analyzed the practice of corporate governance in the companies in Indonesia. Simultaneous testing results show that corporate governance mechanisms influence the capital structure decision of companies listed in IDX in the years of 2007–2009. From determination test, it was found that 18.8% change in capital structure decision (DER) in the companies can be explained by corporate governance variables.

The results reveal a significantly negative influence of board of directors size as well as board of commissaries composition on capital structure decision. However, the influence of family governance, managerial ownership and institutional ownership on capital structure decision (DER) is not apparent.

Further studies are required to formulate more corporate governance variables and to incorporate them into the analysis with different data collection techniques. Future studies could try different control variable to investigate its influence on capital structure decision. This study only used DER to assess the capital structure decision. Future studies should include other ratios.

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