

# Factors Affecting the Financial Performance of Companies Based on Agency Theory

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**Abstract:** This study examines the factors that influence a company's financial performance based on agency theory. There were 5 independent variables used in this study, namely institutional ownership, insider ownership, board size, company size, and debt ratio, as well as the dependent variable, namely the company's financial performance measured using Tobin's Q ratio. This study used a quantitative approach using multiple linear regression analysis methods with a sample of 357 non-financial companies listed on the Indonesia Stock Exchange over the 2013-2017 period. Data processing used Eviews, where the results showed that institutional ownership, insider ownership, board size, company size, and debt ratio simultaneously had a significant positive effect on Tobin's Q. However, if the variables were tested separately, it was found that institutional ownership, insider ownership, and debt ratio had a significant positive effect on Tobin's Q, while firm size had a significant negative effect on Tobin's Q and board size had no significant effect on Tobin's Q.

**Keywords:** Agency theory, corporate governance, financial performance, institutional ownership, insider ownership

## 1 INTRODUCTION

In order to achieve the company's main objectives to maximize the wealth of its owners, the company's financial performance must be excellent. Nevertheless, in reality, the company's financial performance is influenced by many factors. Within companies that separate ownership management from management, agency problem has the potential to occur (Chandra et al., 2015). This agency problem occurs when the manager (agent) acts according to his interests paying no attention to the interests of the owner (principal) (Jensen & Meckling, 1976). To reduce this agency problem and to increase the owner's wealth, the company must incur additional costs called agency costs. These are the costs of monitoring management actions, ensuring that managers do not take dishonest actions, provide incentives for managers (Gitman, 2017). One way that can be done to reduce agency problems and agency costs is that companies can increase institutional ownership and insider ownership so that the company's financial performance will improve (Bathala, 1994).

Lin & Fu (2017) as well as Mishra & Kapil (2017) found that institutional ownership has a sig-

nificant positive effect on the company's financial performance because institutional investors will act as active monitoring that actively oversees the company's activities so that it will reduce agency problems and agency costs (Lin & Fu, 2017). However, contrary to the research, Ping & Hsien (2009) found that institutional ownership has no significant effect on the company's financial performance because institutional investors act as passive monitoring who are only interested in the short-term benefits of the excess information they have so they will not monitor.

Insider ownership is found to have a significant positive effect on Mishra & Kapil (2017) and Ping & Hsien (2009) because with insider ownership there will be an alignment effect between the interests of agents (managers) and principals (owners), so that agency problem and agency costs are reduced (Jensen & Meckling, 1976). However, contrary to the findings of the study, Lin & Fu (2017) found a significant negative effect between insider ownership and company financial performance because insider will try to maintain their position with anti-takeover actions to make the company's financial performance decreases (Lin & Fu, 2017). Not only that, another

variable that can also affect the company's financial performance based on agency theory is board size. This variable is used to investigate the effectiveness of supervision by the board of directors. The board size variable was found to have a significant positive influence on the research of Mishra & Kapil (2017) and Ping & Hsien (2009) because it would provide more optimal supervision and could prevent managers who acted only in their interests. In contrast, Cheng (2008) stated that board size has a significant negative effect on a company's financial performance because more board of directors makes coordination and communication difficult so that more conflicts and agency problems increase (Cheng, 2008). As Indonesia implements a two-tier company organ system, what is meant by the board of directors is the board of commissioners whose job is as a supervisor.

The studies of Lin & Fu (2017), Mishra & Kapil (2017) and Ping & Hsien (2009) found that company size has a significant negative effect on the company's financial performance because the bigger the company, the more agency problems there will be. Nevertheless, contrary to these results, Bharbra (2007) stated that company size has a significant positive influence on the financial performance of companies because larger companies have better economies of scale.

Another control variable, namely the debt ratio which is a proportion of the amount of debt used in corporate funding was found to have a significant negative effect on the company's financial performance by Lin & Fu (2017), Mishra & Kapil (2017) and Ping & Hsien (2009) because more debt is used, the interest expense will be higher so that it will reduce the company's income. Contrary to these results, Ahmad & Jusoh (2014) proposed that the debt ratio has a significant positive effect on the company's financial performance because the company will get additional supervision from creditors and has a higher chance of getting more income than if it did not use debt.

Based on some of these findings, it can be stated that the influence of factors such as institutional ownership, insider ownership, board size, company size, and debt ratios that affect the company's financial performance based on agency theory is still unclear because the results of several studies were varied.

This research will discuss the factors that affect the company's financial performance based on agency theory in Indonesia because financial companies have additional special rules that are different from other companies, the object used was a non-financial

company listed on the Indonesia Stock Exchange over the 2013-2017 period. The company's financial performance was measured using market-based financial performance based on Tobin's Q ratio because it is more in line with financial goals, whereby in this ratio, the stock price can reflect the market's expectation of the company's future revenue (Muttakin et al. 2014).

Based on the background of the problem, the hypotheses used in this study are:

- H1. Institutional ownership (INST) has a positive effect on the company's financial performance (Tobin's Q).
- H2. Insider Ownership (SID) has a positive effect on the company's financial performance (Tobin's Q).
- H3. Board size (BS) has a positive effect on the company's financial performance (Tobin's Q).
- H4. Company size (SIZE) has a positive effect on the company's financial performance (Tobin's Q).
- H5. Debt ratio (LEVERAGE) has a negative effect on the company's financial performance (Tobin's Q).

## 2 RESEARCH METHODS

This research is classified as basic research because it was done to find out and explain a phenomenon. The purpose of this research is included in causal research because it was conducted to test the effect of independent variables on the dependent variables. Based on the approach, this research is a quantitative study because the data used in this study used aspects of measurement, calculation, formulas, and certainty of numerical data.

Based on the research analysis and hypothesis, the variables used in this study can be divided into 1 dependent variable, 3 independent variables, and 2 control variables. The dependent variable in this study was the company's financial performance (Tobin's Q), while independent variables used in this study were institutional ownership (INST), insider ownership (SID), and board size (BS), while the control variables were company size (SIZE) and debt ratio (LEVERAGE).

The type of data used in this study was panel data, which is a combination of time series data and cross-section. The data used were secondary data obtained from the company's annual and financial report. The measurement level used in this research was the ratio level.

The population used in this study was all companies listed on the Indonesia Stock Exchange over the 2013-2017 period. While the sample used was non-

financial companies listed on the Indonesia Stock Exchange over the 2013-2017 period. The sample used was chosen based on the criteria that the company was not placed on a suspended status by the Indonesian Stock Exchange (IDX) and the company must possess an annual report over the 2013-2017 period.

### 3 RESULTS AND DISCUSSIONS

Before conducting a regression test, a classic assumption test was performed first to ensure the results of the study are unbiased and meet the requirements of the Best Linear Unlocked Estimator (BLUE). The assumption tests conducted were normality test, multicollinearity test, and heteroscedasticity test. Autocorrelation test was not done because autocorrelation problems only occur in time series data (Gujarati, 2013).

From the normality test, it was found the Jarque-Bera probability results of 0.000000 where this value indicates that the data are abnormally distributed because the probability value is smaller than  $\alpha = 5\%$  (0.05). However, this abnormality can be justified by the Central Limit Theorem theory, which states that the more data samples used with a minimum of 30 samples will make data distribution normal (Berenson, 2012).

The correlation test between the independent variables and the multicollinearity test found that there were no independent variables that had a correlation greater than 0.8 or -0.8, which was the limitation of the correlation. So it can be stated that the research data is free from multicollinearity problems.

The heteroscedasticity test was performed with the glacier test, which uses absolute residual values. From the test results, it was found that the data had heteroscedasticity where the probability of F was found to be 0.000000, which is smaller than  $\alpha = 5\%$  (0.05). This heteroscedasticity problem can be overcome by weighting generalized least squares (GLS) (Gujarati, 2013).

The panel data produced three research models, namely common effects, fixed effects, and random effects. Thus it is necessary to do the Chow test and the Hausman test to find out which model is the most appropriate for use in research. From the results of the Chow and the Hausman tests, it was found that the best model for this study was the fixed effect model.

From table 1 above, it can be seen the results of research data regression tests using the fixed-effect model and GLS weighting. From these results, it can

be concluded that the variables of institutional ownership (INST), insider ownership (SID), and debt ratio (LEVERAGE) had a significant positive effect on the company's financial performance. Whereas for the variable board size (BS), it was found not to have a significant effect on the company's financial performance and the firm size variable (SIZE) had a significant negative effect on the company's financial performance.

Table 1. Regression Test Results (Tobins Q)

Variables	Beta	Sig. $\alpha$
Inst	0.363672	0.0000***
SID	0.479923	0.0000***
BS	0.000263	0.9171
Size	-0.486729	0.0000***
Leverage	0.600698	0.0000***
R Squared	0.928220	
Adj. R. Squared	0.910011	
F Statistics	50.97378	
Prob. F-Stat	0.000000	

\* Sig.  $\alpha$  at 1%

The F-test was conducted to determine the effect of the independent variables on the dependent variable. From the F-test, it can be seen that the F-statistic probability where the value is found to be 0.000000, thus can be stated that the independent variables (institutional ownership, insider ownership, board size) and control (company size, debt ratio) simultaneously influence the dependent variable (financial performance) significantly at the significance level of 1%.

The variables of institutional ownership and insider ownership were found to have a significant positive effect on financial performance at a significance level of 1% where this is consistent with H1. The board size variable was found to have no significant effect on the company's financial performance; thus H1 was rejected. These results explain that what really influences a company's financial performance is the ability and expertise of the commission and not the amount (Kiel & Nicholson, 2003).

The company size variable was found to have a significant negative effect on the company's financial performance at a significance level of 1% so that H1 was rejected and a type 1 error occurred. These results indicate that in Indonesia the company's size negatively affects the company's financial performance because the larger the companies, the more bureaucratic intervention problems can occur, have higher agency costs, and be less flexible in responding to changing market conditions so that the company's financial performance will decline (Sun & Tong, 2003 in Lin & Fu, 2017).

The debt ratio variable was found to have a significant positive effect on the company's financial performance at a significance level of 1% so that H1 was rejected and a type 1 error occurred. These results indicate that a company's high debt ratio signifies that the company aggressively uses debt funds for growth and has the potential to earn more revenue than if the company does not use debt financing so that the company's financial performance will improve (Mishra & Kapil, 2017). The existence of debt will also increase the supervision of creditors (Hutchinson and Gul, 2004 in Muttakin et al., 2014) and get tax protection (Morck et al., 1988 in Shyu, 2011).

The ability of the research model to explain the influence of the independent variables on the dependent variable can be seen from the adjusted R-squared. From these results, it can be stated that this study is able to explain the effect of independent variables on the dependent variable of 91.0011%, while the remaining 8.9989% is explained by other variables not included in this study.

#### 4 CONCLUSION

Based on the results of research and statistical tests that have been carried out, it can be concluded that the variables of institutional ownership, insider ownership, board size, company size, and debt ratio simultaneously had a significant effect on the company's financial performance (Tobin's Q). However, if tested separately, it was found that institutional ownership had a significant positive effect on the financial performance of companies in which institutional investors acted as active monitors. Insider ownership was found to have a significant positive effect on the company's financial performance, where there was an alignment effect between the interests of managers and owners. The board size variable was found to have no effect on the company's financial performance because ability and expertise are more important than numbers. The company size variable was found to have a significant negative effect because of the larger the company, the higher the agency problem and cost. The debt ratio variable was found to have a significant positive effect because, with debt, the company got additional supervision from creditors.

Recommendations given based on this research are expected to provide benefits and input for investors, companies, and other researchers.

Recommendations for Investors, this study explains the influence of institutional ownership, insid-

er ownership, board size, company size, and debt ratio on the company's financial performance in non-financial companies listed on the Indonesia Stock Exchange (IDX). Thus this research can be a material for consideration and reference for investors when considering factors that can affect the financial performance of companies in choosing stocks to invest in non-financial companies in Indonesia.

Recommendations for Companies, for non-financial companies, this research can be taken into consideration in the management of good corporate governance and how to reduce agency problems that can improve the company's financial performance. Companies should pay more attention to factors that can improve and reduce the company's financial performance so that the company's financial performance can be improved better.

Recommendations for Further Researchers, this research can add knowledge and insight as well as be used as a reference to the factors that can affect the company's financial performance based on agency theory, among others, the effect of institutional ownership, insider ownership, board size, company size and debt ratio. This study has limitations, namely the short observation period, the existence of insignificant research results, and the variable used was only 5. For further research, it is recommended to increase the observation period and the number of variables, while the board size variable should be separated between independent commissioners and ordinary commissioners.

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