

The Role of Corporate Governance Mechanism in Enhancing Firm Value

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ABSTRACT

This research aims to examine the influence of corporate governance mechanism to enhance firm value. The corporate governance mechanism uses three variables: managerial ownership, independent commissioner, and audit committee. The population of this research is manufacturing companies listed in the Indonesia Stock Exchange during the period of 2015-2018, from which 144 companies were selected as the sample. The hypothesis testing was conducted through multiple regression analysis. This research finds that audit committee, independent commissioner, and managerial ownership have a positive and significant effect on firm value.

Keywords: *audit committee, independent commissioner, managerial ownership, firm value, multiple regression analysis*

1. INTRODUCTION

Manufacturing industry in Indonesia still has positive chances to increase and expand. Therefore, the government is committed to create a conducive business climate by providing fiscal facilities and easing business license. They keep pushing industrial downstream policy because it can boost national economic growth significantly. The strategic step is in accordance with the implementation of road map of Indonesia 4.0, which aims to revitalize manufacturing sector to have global competitiveness in the industry 4.0. Hence, the Government emphasizes the importance of conducting economic transformations, from consumption-based economy to manufacturing-based economy. Indonesia is one of the four Asian countries that have the highest plus point of manufacturing sectors in the world. The plus point by national industry increased by USD 34 billion, from USD 202.82 billion in 2014 and to USD 236.69 in 2018. The Indonesia manufacturing Purchasing Managers Index increased from 49.9 in January to 50.1 in February 2019. It means that investors in industry sector know that Indonesia is able to manage its economy well. This economic management improves firm value.

The increase of firm value can be achieved if there is a good cooperation between management company and other parties including shareholders and stakeholders. In fact, similar interest between management and company owners often causes problems. The problem between managers and shareholders is called agency problem. Agency problem is a separation between the principal (investor) and control (agent/manager). Agency problem

will cause failure in achieving company's objectives, which is to increase the value of the company by maximizing shareholder's wealth. Therefore, a control for monitoring and supervision is required to achieve company's objectives.

According to Barnhart & Rosenstein [1], corporate governance mechanism is divided into two. The first is internal mechanisms, including managerial ownership, board of commissioners, the size of board of directors, institutional ownership, the existence of audit, and independent board of commissioners. The second is external mechanisms, such as control by market and debt financing levels. Corporate governance mechanism improves the supervision for company, so the performance of the company will be better, and firm value can increase. Chalevas and Tzovas [2] found that the mandatory corporate governance mechanisms decrease firms' weighted average cost of capital, increase firm's financing, and do not influence firms' effectiveness and earnings manipulation. Chiang et al. [3] found that elections led to lower earnings quality, but better corporate governance led to greater earnings quality. In the presence of board of elections, earnings reduce value relevance, but book value increases value relevance. Finally, given the board of elections, the relative value relevance of earnings and book value on stock price is not fully moderated by strong corporate governance.

Indonesia's rank in ASEAN Corporate Governance Scorecard has improved, from the average country value of 62.88 in 2015 to 70.59 in 2017, driven by banking industry, Aneka Tambang (a mining company), and Jasa Marga (a highway company). Various policies to restore economic activity have been implemented by the Government, including several regulations to improve transparency and consistency of companies and to encourage the creation of Good Corporate Governance. One of the approaches in

determining the value of intrinsic stocks is the price book value (PBV), which shows how far a company is capable in creating firm values that is relative to the total of invested capital. Higher PBV ratio implies that a company has created values for its shareholders [3-5].

2. HYPOTHESES DEVELOPMENT

2.1 The Relationship Between Audit Committee and Firm Value

Audit committee is responsible for supervising the preparation of financial statements, supervising external audits, and supervising internal control systems (including internal audits) that reduce the possibility from earnings management. Audit committee is assigned to provide an independent professional opinion to board of commissioners regarding matters delivered by directors and identifying those which require the attention of board of commissioners to increase firm value. The stricter the supervision conducted by the audit committee, the smaller the earnings management, and the higher the firm value. Mersni and Ben [6] showed that discretionary loan loss provisions are negatively related to the existence of an audit committee. This indicates that small sharia supervisory boards are more effective than larger ones, which could be due to the higher costs and negative effects of large groups on decision-making. The results also highlight that the existence of scholars with accounting knowledge sitting on the sharia board reduces discretionary behavior. Additional results provide evidences that an external sharia audit committee can reduce discretion in Islamic banks. The reduced discretionary behavior can improve firm value. Al-Thuneibat et al. [7] revealed that there is no statistically significant effect of audit committee on earnings management. Kolsi and Grassa [8] said that audit committee meetings have a negative relationship with discretionary Loan Loss Provision, which finally can improve firm value. H₁: Audit committee has a positive relationship with firm value

2.2 The Relationship Between Independent Commissioner and Firm Value

Fama and Jensen [9] stated that non-executive director may act as intermediary in disputes between internal managers, supervise management policies, and give advices to management. Independent commissioner is in the best position of implementing monitoring function in order to create a company with good corporate governance. Orr et al. [10] found that board composition of high growth option firms is positively related to firm value, and this relationship

is maintained when more refined measures that proxy the characteristics of outside directors (such as tenure of outside directors, the level of outside director equity ownership, the number of other board positions held by outside directors, and the total proportion of non-executive directors, including grey directors) are recognized. Kolsi and Grassa [8] showed that Islamic Banks with large Shariah Board size manage less discretionary Loan Loss Provision. Accounting and Auditing Organization for Islamic Financial Institutions membership positively impacts earnings management through discretionary Loan Loss Provision in Islamic Bank. There is a negative relationship between boards of director's independence and the extent to which Islamic Bank manages discretionary Loan Loss Provision. Finally, it can improve firm value.

H₂: Independent commissioner has a positive relationship with firm value

2.3 The Relationship Between Managerial Ownership and Firm Value

Managerial ownership is the percentage of shares owned by the management from all company stocks capital. Jensen and Meckling [11] stated that a way to reduce agency cost is to increase stock ownership by management. The proportion of stock ownership controlled by managers can affect company policies. Managerial ownership will align the interests of management and shareholders (outsider ownership), so that it will obtain direct benefits from the decision taken and taking the loss as a consequence of the wrong decision making.

Ahmed and Nor [12] found that the role of managerial ownership in mitigating agency conflict of free cash flow and improving earnings predictability is more prominent in larger firms. This study implies that investors still have reservations about the ability of boards to enhance earnings numbers in Malaysia, although efforts were taken to reform the corporate governance mechanisms following the Asian financial crisis. Du et al. [13] found that managerial ownership and firm value affect each other positively.

H₃: Managerial Ownership has a positive relationship with firm value

3. RESEARCH METHODS

The population in this research is all companies listed in the Indonesia Stock Exchange in the period of 2015-2018. The sample was selected using purposive sampling with the criteria of (1) Manufacturing companies listed in the Indonesia Stock Exchange in the period of 2015-2018; (2) Manufacturing companies that presented annual report in 2015-2018 in rupiah; (3) Manufacturing companies that disclosed annual corporate governance reports; and (4)

Manufacturing companies that have completed the data relating to the variables of this study. This study uses the secondary data from www.idx.co.id regarding the 144 manufacturing companies, collected through documentation method on annual reports published by the companies during the research period in their websites.

The variables and indicators in this study include (1) managerial ownership, measured from the percentage of shares owned by the management from all company capital stocks, (2) size of the independent board of commissioners, measured by the percentage indicators of the commissioner board from outside the company, (3) audit committee, using dummy variables (company that has audit committee will be given the value of 1, while company that does not have any audit committee will be given the value of 0), (4) firm value, represented by PBV as the comparison between market price per share with the value of the book per share. All data was analyzed using logistic regression [14].

4. RESULTS

Regression analysis finds that audit committee (AC) \square FV ($\beta = 0.235$, $p\text{-value} < 0.05$), Independent of commissioner (IC) \square FV ($\beta = 0.144$, $p\text{-value} < 0.05$), and managerial ownership (MO) \square FV ($\beta = 0.418$, $p\text{-value} < 0.05$). This result provides support for H1, H2 and H2.

Table 1. Hierarchical Regression Analysis

Hypothesis	Regression	Beta	t	p-value	Decision
H1	AC* \square FV****	0.235	1.434	.001	Accepted
H2	IC** \square FV	0.144	1.116	.000	Accepted
H3	MO*** \square FV	0.418	2.624	.012	Accepted
Adj R ² = 0.611, F = 146,131, $p\text{-value} = 0.00$					

*AC = Audit Committee

**IC = Independent of Commissioner

***MO = Managerial Ownership

****FV = Firm Value

5. DISCUSSION

5.1 The Relationship Between Audit Committee and Firm value

Based on table 1, audit committee has a positive relationship with firm value. It means that audit committee in manufacturing companies plays its function as a supervisor

to monitor the company. The result of this research is consistent with a research of Mersni and Ben [6] and Al-Thuneibat et al. [7], which revealed that statistically significant effect for audit committee on earnings management was detected, so it can improve firm value. It is in contrast with the research of Kolsi and Grassa [8].

5.2 The Relationship Between the Size of Independent Board of Commissioners and Firm value

Table 1 shows that the size of independent board of commissioners has positive relationship with firm value. In addition, the board directs the manufacturing companies, so they run the business based on its firm value.

The independence level of commissioner is run and fulfilled the expectation. This means that the conflict between manager (agent) and company owner (principal) can be solved by the board.

The finding of this research is consistent with a research of Orr et al. [10] that the board composition of high growth option firms is positively related to firm value, and this relationship is maintained when more refined measures that proxy the characteristics of outside directors (such as tenure of outside directors, the level of outside director equity ownership, the number of other board positions held by outside directors, and the total proportion of non-executive directors, including grey directors) are recognized. This finding is different from the study of Kolsi and Grassa [8].

5.3 The Relationship Between Managerial Ownership and Firm Value

Based on table 1, it can be concluded that managerial ownership is strongly correlated with firm value. In other words, a manager who has stock in the company feels that the company is a part of himself. Thus, the manager will not do any misconduct. Therefore, managerial ownership can decrease moral hazard by the manager (agent) because of the sense of belonging to the company. This result is in line with Ahmed and Nor [12] and Du et al. [13] that managerial ownership and firm value affect each other positively.

6. CONCLUSIONS

The results show that audit committee, independent commissioner, and managerial ownership have positive and significant relationships with firm value. Therefore, corporate governance mechanism succeeded in enhancing firm value because it can reduce conflicts of interest between manager (agent) and company owner (principal). This research is limited in that the information about

managerial ownership is not disclosed in annual report or in good corporate governance report. Therefore, future researches can use other measurements of ownership structure in corporate governance mechanism such as institutional ownership or family ownership.

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