Advances in Social Science, Education and Humanities Research (ASSEHR), volume 186
15th International Symposium on Management (INSYMA 2018)

# Interdependency between internationalization, firm performance, and corporate governance

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ABSTRACT: The purpose of this research was to identify the interdependency between internationalization, performance and corporate governance. Data used by this paper were from financial statement information of manufacturing companies listed on Indonesian Stock Exchange over period 2011-2015. Pooling data were applied for a sample which contains 84 manufacturing companies with five years data. This paper also applied Two Stages Regression as a statistical tool to identify the relationship between these three main variables. This research found significant interdependency relations between internationalization, performance, and corporate governance of manufacturing companies listed on Indonesia Stock Exchange.
*Keywords*: internationalization, performance, corporate governance

## 1 INTRODUCTION

In the era of globalization, companies all over the world intend to internationalize themselves to increase their market share and take a part of global markets. It is important as Jane (2012) mentioned that they are able to reach new markets and acquire new sources of capital globally. They also can diversify corporate risks and reduce costs so they are going to have a strong competitive advantage. In its process, internationalization affects the companies' activities. Companies surely will meet the risk exposures namely currency risk, liquidity risk and tax risk. Another potential risk comes from the host country such as social, cultural legal formal aspects and even terrorism.

Some papers furthermore have found that internationalization process will also affect companies' performance. Hosea & Marciano (2015) pinpointed three levels that affect the firms' performance during the process of internationalization. At the low level, there will be a negative relationship. As companies enter the new global market, they will have to solve information asymmetry. At the medium level, increasing firms' performance occurs as companies are able to manage and solve asymmetric information problem in the global market. Finally, at a high level of internationalization, firms' performance decreased as they are unable to manage the complexity of an increasing pressure in the global market.

Zhang et al. (2012) remarked that on the one hand, internationalization requires the companies to do a lot of things in the new global market. On the other hand, performance can also affect companies' internationalization. Jung & Bansal (2009) argued that performance affects internationalization in two ways. First, performance takes the role of a benchmark. Companies compare their actual performance with last period performance and other companies' performance. They will make strategic planning and decision based on the comparison results. Second, the increased performance could change companies' behavior and encourages them to be more risk-taking. By having increased performance, they become more confident to manage more risk and even reach the global market to internationalize.

Furthermore, internationalization also affects companies' corporate governance. As stated by Al Mamun & Badir (2014), companies need to expand its internal and external corporate governance mechanism to maintain its competitive advantage. The authors also found that internationalized companies implement its governance using the intra-convergence and inter-convergence. Heinrich (2005) also stated that the effects of internationalization on corporate governance perceived in 1999, since the end of crisis-era in Asia.

On the other hand, companies with well-implemented governance will not find any difficulties in internationalization process as suggested by He & Cui (2012) in China that multinational companies having well-implemented governance will also have better performance in their internationalization activity. Corporate governance implemented by applying straight rules inside the companies so they will feel safe and more confident. Moreover, Felicio et al (2016) stated that corporate governance affects companies' internationalization by implementing the global mindset. Another research by Calabro et al (2016) found a negative correlation between corporate governance and internationalization in Germany family-based companies. They suggested that the lower family involvement in corporate structure will lead German companies to a better-implemented internationalization.

In another opinion, Kowalewski (2016) wrote that well-implemented corporate governance will lead companies to performance optimization. His research in Poland found that well-implemented corporate governance will lead companies to a healthy profitability, even in the crisis era. Other research by Tuan (2014) also found that well-implemented corporate governance supports companies' brand performance.

Besides that, performance can also affect the corporate governance. The increase of performance allows companies to improve its governance. However, Cho & Kim (2003) wrote that the worse companies' performance will lead to a better governance implementation, expecting a better performance on the next period. Furthermore, Republic of Indonesia government projected a more competitive Indonesia in the international market. But it is not supported by Indonesian companies' internationalization decreasing trend. So, this research will also identify the market phenomenon and its correlation to the government's projection

## 2 RESEARCH METHODS

This research used secondary data, which is panel data and it is a combination of the cross-section and time series over period 2011-2015. The data were taken from companies' financial reports obtained from Indonesia Stock Exchange on www.idx.co.id.

The population of this study was manufacturing companies listed on Indonesia Stock Exchange from 2011-2015, which have to fulfill some criteria i.e. publish financial statements every period from 2011-2015 and provide every data required for this research. Hence, there are 84 manufacturing companies with the observation period from 2011-2015. As a result, there is 420 number of observation.

The model of analysis used two-stage least squares (2SLS). The first stage is the correlation test between the instrumental variables with their control variables. The second stage is the correlation test between the instrumental variables (dependent) with the tested instrumental variables (independent)

## 3 RESULTS AND DISCUSSION

From the first stage regression, there are 3 new fitted variables; they are $DOI_{FITTED}$, $ROA_{FITTED}$, and $DFO_{FITTED}$. In the second stage regression, the test will be engaged between instrumental variables (dependent) and the fitted variables (independent) and the instrumentals' control variables.

The Eviews result shows the two-stage least square (2SLS) results of every correlation.

Table 1. First Stage Regression Result

| Variables | DOI Coef.Reg. (t-stat) | ROA Coef.Reg. (t-stat) | DFO Coef.Reg (t-stat) |
|---|---|---|---|
| $DOI_{FITTED}$ | - | - | - |
| $ROA_{FITTED}$ | - | - | - |
| $DFO_{FITTED}$ | - | - | - |
| CAPEXTLS | 0.74*** (16.90) | - | - |
| DINTASSET | 0.32*** (4.11) | - | - |
| ITR | - | 0.00*** (8.08) | - |
| CASHRATIO | - | 0.01*** (14.45) | - |
| FIRMSIZE | - | - | 0.02*** (27.79) |
| DEBTRATIO | - | - | 0.01 (0.61) |
| N | 420 | 420 | 420 |
| Adj.$R^2$ | 0.26 | 0.30 | 0.03 |

Based on the first stage regression, it can be seen in $DOI_{FITTED}$ model that both capital expenditures and degree of intangible assets significantly and positively affect companies' internationalization. It can be said that the companies used most of their capital expenditure to support their internationalization process. Within intangible assets, they make a barrier to entry to other companies so it will be difficult to enter the market in the same host country. In $ROA_{FITTED}$ model, both performance's control variables also significantly and positively affect companies' performance. Inventory turnover ratio clearly affects companies' performance. The higher ratio means companies are able to sell their average inventory in a period and it will lead them to a good profitability. The cash ratio correlation finding is consistent with Alipour (2013), suggesting that the more liquid companies will have better return on assets and Tobin's Q ratio. Next, in *$DFO_{FITTED}$* model, we found the same correlation pattern as two models' pattern before. Both firm size and debt ratio control variables significantly affect corporate governance proxied by the degree of foreign ownership. It is consistent with Bereskin et al. (2015), suggesting that good credit rating companies will have to maintain their creditors' trust by improving their governance and policy so the creditors will keep on financing the companies.

Table 2. First Stage Regression Result.

| Variables | Second Stage Regression<br>DOI<br>Coef.Reg.<br>(t-stat) | ROA<br>Coef.Reg.<br>(t-stat) | DFO<br>Coef.Reg<br>(t-stat) |
|---|---|---|---|
| DOI $_{FITTED}$ | - | 0.00***<br>(2.92) | -0.07***<br>(-4.58) |
| ROA $_{FITTED}$ | 0.07***<br>(5.36) | - | 0.14***<br>(3.14) |
| DFO $_{FITTED}$ | 0.06***<br>(12.40) | 0.01***<br>(4.04) | - |
| CAPEXTLS | 0.62***<br>(12.46) | - | - |
| DINTASSET | 0.32***<br>(3.37) | - | - |
| ITR | - | 0.00***<br>(4.01) | - |
| CASHRATIO | - | 0.01***<br>(12.66) | - |
| FIRMSIZE | - | - | 0.02***<br>(25.53) |
| DEBTRATIO | - | - | 0.04<br>(1.98) |
| N | 420 | 420 | 420 |
| Adj.$R^2$ | 0.33 | 0.22 | 0.11 |

Furthermore, based on the second stage regression table, it can be seen that in *DOI* model, *$ROA_{FITTED}$* and *$DFO_{FITTED}$* variables significantly and positively affect companies' degree of internationalization. The finding supports Seifert & Gonenc (2015) that the multinational companies have a high rate of cash savings to finance their international activity. A possible explanation for this finding is that well-performed companies lead themselves to have good cash flows. Thus, they have extra fresh money to support their international activity. This finding also supports Jung & Bansal (2009) on how performance affects companies' internationalization. But it still requires further research to prove those performance effects in Indonesia manufacturing companies. Moreover, the *$DFO_{FITTED}$* correlation finding is consistent with Felicio et al. (2016) suggesting the governance implemented applying continuity between corporate global mindset and individual global mindset.

In *ROA* model, it is also found that both *$DOI_{FITTED}$* and *$DFO_{FITTED}$* show the same correlation patterns as *DOI* model. It is consistent with Mauri & Figueiredo (2012) that the internationalization reduces performance instability by engaging geographical dispersion and outsourcing. Both are the methods of risk diversification that allow companies to reach performance optimization. Besides that, the *$DFO_{FITTED}$* correlation finding is consistent with Kowalewski (2016), suggesting that the well-implemented governance will lead companies to a better profitability. The correlation finding also means that the corporate governance implementations are able to support companies' performance optimization by reducing the agency problem. Misra & Moshanty (2014) proposed that companies can implement the governance by using the proactive indicator as the internal target. Another opinion by Malik & Makhdoom (2016) stated that governance can also be implemented by trimming the board of director structure that will support independence and transparency. Within implementation, it will be easier to make strategic decisions and the most important thing, it is able to reduce agency problem.

Furthermore, in *DFO* model, it can be seen that *DOI* significantly and negatively affects corporate governance. A possible explanation for this finding is the phenomenon of Indonesian local market. Data from Indonesian Bureau of Statistic shows that the Indonesian local market grows from year to year. This condition stimulates local firms to focus to operate only in the local market and ignore internationalization opportunity. The strong local market also will invite foreign investors to invest in Indonesia, expecting the high rate of return. However, *ROA* significantly and positively affects corporate governance. It doesn't support Cho & Kim (2003) statement that worse companies' performance will lead to a better governance implementation, expecting a better performance on the next period. Again, it still requires further research to identify this correlation.

## 4 CONCLUSION

In DOI model, it is found that the performance and corporate governance significantly and positively affect internationalization. In ROA model, it is found that the internationalization and corporate governance significantly and positively affect the performance. Finally, in DFO model, it is found that internationalization significantly and negatively affects the degree of foreign ownership. But, a different result is shown by performance variable affecting the degree of foreign ownership.

Reacting to the Indonesian government's projection, manufacturing companies need to welcome the FDI, so it will support their internationalization activity. However, the role of the government is highly required to reduce agency problem, so foreign entity could not fully conquer Indonesia's natural resources..

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