

Corporate Governance Mechanism and Cost of Capital to Firm Value

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This study examines the use of corporate governance to the cost of capital and corporate value. Corporate governance is a set of rules which manages the relationships between stakeholders, government, internal and external parties, employees and management that are related to their rights and obligations. The proxies used for corporate governance variables are independent commissioners, board size, managerial ownership, institutional ownership and non-institutional ownership. The research method used is panel data regression. The sample used in this study is non-financial listed on the Indonesian Stock Exchange (IDX) in the period 2008-2018. The results of this study indicate that variables of corporate governance, such as independent commissioners, board size, managerial ownership and institutional ownership, have a significant influence on capital costs. The results of this study also found that variables of corporate governance mechanism such as board size, institutional ownership, and non-institutional ownership significantly influence the firm's value (Tobin's Q).

Key words: *Corporate Governance, Cost of Capital, Tobin's Q, Firm Value, Ownership.*

Introduction

Lack of transparency in a company will lead to agency problems, which then will continue to become agency conflict. Agency conflict is a conflict that occurs because of the desire of the management to act following its own interests, which can sacrifice the interests of shareholders to obtain long-term returns and value (Alijoyo and Zaini, 2004). The existence of agency conflict will also lead to the emergence of agency cost as the amount of the cost of the principal to conduct the supervision of agents (Jensen and Meckling, 1976). With the agency problem, corporate governance comes as a mechanism that minimises the occurrence of agency problems that occur between owners and managers, as a way to merge the unity of interests between two parties. Corporate governance can be done by improving supervision and control over the behaviour of management, limiting the manager's opportunistic



behaviour and reducing the risk of information that shareholders will receive.

Corporate governance (CG), according to the Forum for Corporate Governance in Indonesia (FCGI), is a set of rules governing relationships between shareholders, managers of companies, creditors, governments, employees and other internal and external holders, relating to their rights and obligations. By looking at the definition, it can be said that corporate governance is a control system for a company. Corporate governance itself has a goal, where the goal is to create added value for all stakeholders. Corporate governance also provides a requirement for each company to have control or monitoring of performance, structure and tools in order to achieve their goals (OECD, 1999). In addition, according to the National Committee on Governance Policy (KNKG, 2006), there are several basic principles contained in corporate governance, such as transparency, accountability, responsibility, independence and fairness.

According to the OECD Principles of Corporate Governance (2004), corporate governance is also a key element in increasing efficiency and economic growth while increasing investor confidence. Good corporate governance will help to increase domestic investor confidence, reduce capital costs, support the functioning of financial markets, and then encourage more stable sources of financing. The OECD also says that good corporate governance has the advantage of lending some funds in a large amount.

In implementing corporate governance in a company, it will certainly not be separated from some procedure or a clear relationship between the parties that will control or supervise the relevant decisions, which is called the mechanism of corporate governance (Akhmad, 2002). According to Gillan (2006), the corporate governance mechanism is divided into an internal mechanism and an external mechanism. Internal mechanisms are a way to control a company by using internal structures and processes, like at a company such as RUPS, such as by the composition of the board of directors, the board of commissioners, and also meetings being held with the board of directors. The external mechanism is a means of controlling a company by using external structures and processes outside the company, whether economic, legal or social (Iskandar and Chamlaio (2000) in Lastanti (2004). The implementation of corporate governance in a company becomes important, especially since the occurrence of such cases in companies in America like Enron and Worldcom. Lack of supervision of management within the company caused the company to collapse due to a strategy that manifested a fraudulent practice by unknown top management over a considerable period of time (Kaihatu, 2006). For the continent of Asia (including Indonesia), the issue of corporate governance began to become a concern for many people in mid-1997, when the economic crisis was taking place in Asian countries (Indaryanto, 2004).

In Indonesia, the implementation of corporate governance became important after the

economic crisis that occurred in 1997. The economic crisis that occurred in 1997 caused some companies in Indonesia to go into bankruptcy. One trigger of the economic crisis was the lack of transparency by companies in managing all aspects of their companies. Lack of transparency in a company creates fraudulent practices from individual management, for example, the cost of funding or the cost of capital for the company may have increased. The cost of capital can increase as the transaction costs in the company become higher. The existence of this ultimately encourages multilateral financial institutions to issue a requirement for better practices and the implementation of corporate governance in this country improved. It also encourages the Indonesian government to issue a Decree of the Minister of state-owned enterprises no. Kep-117 / M-MBU / 2002 dated August 1, 2002, which emphasises the obligation for all of the state-owned enterprises to applied good corporate governance consistently and/or to make the principles of good corporate governance as its operational foundation. This aims to improve business success and the accountability of the company in order to realise shareholder value in the long term, by still paying attention to the interests of other stakeholders, and is based on legislation and ethical values.

Research on corporate governance has been one of the most exciting research subjects of financial literature researchers. Research on CG by Black, Jang and Kim (2003) shows that there is a positive relationship between the overall corporate governance index in Korea and firm value. In addition, the results of research from Ashbaugh, Collins and LaFond (2004) shows that the variables of corporate governance have a significant effect on the cost of equity capital of a company. Further research on CG conducted by Pham, Suchard and Zein (2012) shows that variables insider ownership in larger firms, the presence of institutional blockholders and independent counsels all have the function of reducing risk and level the asymmetry of information faced by companies and their investors. All of these variables, thereby reduce the cost of capital and create value for a company's shareholders.

In Indonesia, research on corporate governance has been undertaken by several researchers with different results. A study by Adam et al. (2015) reveals that variables commissioners, audit committees, managerial ownership and institutional ownership do not affect the cost of debt. Research by Wisudanto, Rachmawati and Budiarjo (2016) on CG on the cost of equity of capital with the influence of disclosures, earnings announcements and managerial ownership as variables of corporate governance show that: (1) disclosure and public ownership have a negative impact; (2) earnings announcements have a positive effect; and (3) managerial ownership does not have an impact on the cost of equity capital. Research on the influence of corporate governance on the cost of capital and corporate value has not received much scrutiny.

This study will discuss the influence of corporate governance on the cost of capital to firm

value. This study refers to research conducted by Pham, Suchard and Zein (2012). The proxies of corporate governance variables in this study are; board independence, board size, insider ownership and institutional ownership. This measurement is the same as the measurement of the study conducted by Pham, Suchard and Zein (2012). The size of company characteristics is used as a control variable. Furthermore, cost of capital as the dependent variable in this study is measured by the weighted average cost of capital, while Tobin's Q measures the firm value.

Literature Review

Research on the topic of corporate governance has been conducted by researchers from within Indonesia and abroad. These studies include Pham, Suchard and Zein (2012); Yves Bozec and Richard Bozec (2010); Ashbaugh, Collin and LaFond (2004); Wisudanto, Rachmawati and Budiarjo (2016); and Adi, et al. (2013).

Based on previous research conducted by Pham, Suchard and Zein (2012), corporate governance influences the cost of capital. Also, in this study, corporate governance does not influence corporate value.

Research by Yves Bozec and Richard Bozec (2010) examines the relationship between corporate governance scores and capital costs (including equity capital costs and debt capital costs). The quality of corporate governance in this study is measured by the ROB index published by The Globe and Mail. The results of this study indicate that the cost of capital decreases with the quality of corporate governance, where companies with high ROB value have low equity costs and debt costs.

Ashbaugh, Collin and LaFond (2004) conducted a study that aims to examine the effects of corporate governance on the cost of equity capital. The results of this study indicate that the quality of a company's financial information has a negative relationship to the cost of equity capital. Also, the ownership structure, stakeholder rights and board structure affect the cost of equity capital indirectly through the beta.

The prior research in Indonesia conducted by Wisudanto, Rachmawati and Budiarjo (2016) aims to examine the effect of corporate governance as measured by disclosure, ownership structure, and earnings announcement on capital costs at manufacturing companies listed on the Indonesian Stock Exchange 2012 and 2014. Results from this study show that disclosure and public ownership have a negative effect on the cost of equity capital, while earning announcements have a positive influence.

Adi et al. (2013) examined the effect of corporate governance and capital structure on risk, financial performance and firm value. This study has revealed that corporate governance has no effect on corporate risk, but has a positive relationship when there is good governance of financial performance and firm value. Meanwhile, the capital structure has an inverse relationship with corporate governance.

Methodology

This research is included in the research using a quantitative research approach. The data used in this research is quantitative data. This research belongs to the category of panel data research. The sample of this study consists of 1199 non-financial companies listed on the Indonesian Stock Exchange during the period 2008-2018. The data in this study are obtained from the financial statements of each company, namely, Datastream, TICMI (The Indonesian Capital and Market Index) and Thomson Reuters.

The study has two objectives, firstly, to analyse the influence of corporate governance on capital cost and secondly, to analyse the influence of corporate governance on corporate value (Tobin's Q). Here is a model to analyse the effect of corporate governance on the cost of capital:

$$\begin{aligned} WACC_{it} = & \beta_0 + \beta_1 BOARDINDEP_{it-1} + \beta_2 \text{Log}BOARDSIZE_{it-1} + \beta_2 INSIDER_{it-1} \\ & + \beta_2 INSIDER_{it-1}^2 + \beta_3 INSTBLOCK_{it-1} + \beta_4 NONINSTBLOCK_{it-1} \\ & + \sum_{K=1}^K \delta_k x_{it-1}^k + \lambda_i + \varepsilon_{it-1} \end{aligned}$$

Then, for the model used in analysing the influence of corporate governance on corporate value (Tobin's Q) is the following:

$$\begin{aligned} Q_{it} = & \beta_0 + \beta_1 BOARDINDEP_{it-1} + \beta_2 \text{Log}BOARDSIZE_{it-1} + \beta_2 INSIDER_{it-1} \\ & + \beta_2 INSIDER_{it-1}^2 + \beta_3 INSTBLOCK_{it-1} + \beta_4 NONINSTBLOCK_{it-1} \\ & + \sum_{K=1}^K \delta_k x_{it-1}^k + \lambda_i + \varepsilon_{it-1} \end{aligned}$$

WACC is the dependent variable of the first research objective, where this variable is the cost of capital calculated using the formula of Weighted Average Cost of Capital. **Q** is the dependent variable of the second research objective, where this variable is the value of the company, known as Tobin's Q. **BOARDINDEP** is the percentage of the number of independent commissioners that can be obtained by knowing the number of independent commissioners and the board of commissioners of the company. **LogBOARDSIZE** is the

result of the logarithm of the number of boards of directors contained in the companies included in this research. **INSIDER** is a percentage of managerial ownership, which can be seen from the total shares owned by the manager in a company, then for **INSTBLOCK** is a percentage of institutional ownership (ex. government), this can be seen from the total shares owned by the government in a company. **NONINSTBLOCK** is a percentage of non-institutional ownership, which can be seen from the total of shares owned by the parent company or holding company in the companies included in the research. $\sum_{k=1}^K \delta_k x_{it-1}^k$ is a control variable of firm characteristics that have the potential to affect the cost of capital and firm value. All of the explanatory variables are lagged by one period to minimise any potential endogeneity.

Research by Pham, Suchard and Zein (2012) finds that greater managerial ownership, the presence of smaller and more independent institutional ownership and the board will reduce the risk level and information asymmetry, and that this will also help reduce the cost of capital. Furthermore, referring still to this study, the variables of corporate governance do not affect the value of the company. Therefore, the hypotheses in this study are:

H1: The influence of corporate governance mechanisms (independent commissioners, managerial ownership and institutional ownership) on cost of capital of non-financial companies listed on the Indonesian Stock Exchange during the period 2008-2018

H2: There is no effect of corporate governance mechanism on corporate value (Tobin's Q) on non-financial companies listed on the Indonesian Stock Exchange during the period 2008-2018.

Results

This study, as mentioned previously, focuses on the influence of corporate governance on capital costs and uses panel data as a methodology in research. Table 1 shows the variables used in this study, along with the proxies. Table 2 shows the statistical descriptive of the variables used in this study.

Table 1: Definition of Research Variables

Variable	Definition/Proxy
Dependent Variable	<i>Cost of Capital and Firm's Value</i>
Cost of Capital	Weighted Average Cost of Capital (WACC)
Firm's Value	Tobin's Q
Independent Variable	<i>Corporate Governance</i>
Board Indep	% Independent Commissioners
LogBoard Size	Logarithm Board of Directors
Insider	% Managerial Ownership
Inst-block	% Institutional Ownership
Non Inst-block	% Non-Institutional Ownership
Control Variable	<i>Firm's Characteristics</i>
CAPEX/TA	Ratio Capital Expenditure to Total Assets
LogTA	Logarithm Total Assets
TANA/TA	Ratio Total <i>Tangible Asset</i> to Total Assets
TL/TA	Ratio Total Liabilities to Total Assets
BM	Book to Market Value (for WACC)
SD	Standard Deviation from Monthly Stock Returns (for Tobin's Q)

Source: Pham, Suchard and Zein (2012)

Table 2: Descriptive Statistics

Descriptive Statistics of Variables				
Variables	Mean	Median	Maximum	Minimum
Board Indep	0.393493	0.333333	2.500000	0.000000
Board Size	9.153461	8.000000	23.00000	2.000000
Insider	0.050043	0.041667	0.500000	0.000000
Insider ²	0.005028	0.001736	0.250000	0.000000
Instblock	0.458460	0.501148	1.008175	0.000000
Non Instblock	0.189140	0.000000	1.468470	0.000000
CAPEX/TA	0.060295	0.039853	1.000000	-0.255521
LogTA	12.35824	12.31297	15.68839	10.22115
TANA/TA	0.000387	0.000401	0.013418	-0.002532
TL/TA	0.561778	0.523277	8.291758	4.24E-05
BM	0.001164	0.000297	0.080093	-0.019510
SD	0.230733	0.112687	37.49913	0.000000
Tobin's Q	1.569247	1.014523	37.22663	0.000527
WACC	0.131295	0.046234	8.734431	-1.574475

Source: Processed Data by Eviews

Table 2 shows the descriptive statistics of the variables studied. Through table 2, it can be seen that the percentage of independent commissioners (board indep) in non-financial companies listed in the Indonesian Stock Exchange (IDX) for the period 2008-2018 as a whole has an average of 39%. This proportion of independent commissioners indicates that management in the company can be said to be good or comply with the rules of the Indonesian Stock Exchange, which says that good corporate management at least has an independent commissioner of 30% of the total commissioner. In the board size variable, there is 2 to 23 board of commissioners along with directors in the companies included in this study sample. For managerial ownership, almost all firms in this study have a 5% ownership, although there are still some companies that have no managerial ownership. Then, the institutional ownership in this study has an average of 45% and non-institutional ownership 18%. This result indicates that institutional ownership dominates the most substantial average ownership of firms from the sample of this study.

Table 3a: Regression between Cost of Capital and Corporate Governance variable

Dependent Variable: Cost of Capital (WACC)				
Variables	Coefficient	Std. Error	t-Statistic	Prob.
Board Indep	0.043747	0.019154	2.283967	0.0226**
Board Size	0.004515	0.001053	4.287200	0.0000*
Insider	-0.289986	0.098781	-2.935628	0.0034*
Insider ²	0.632743	0.163334	3.873929	0.0001*
Instblock	-0.038481	0.014624	-2.631407	0.0086*
Non Instblock	-0.022360	0.024030	-0.930487	0.3523
CAPEX/TA	0.099828	0.042037	2.374745	0.0177**
LogTA	0.012702	0.012197	1.041415	0.2979
TANA/TA	46.77111	21.26180	2.199772	0.0280**
TL/TA	-0.074344	0.011783	-6.309321	0.0000*
BM	0.144558	0.462943	0.312259	0.7549

Source: Processed Data by Eviews

Note:

*** Significance at 10%

** Significance at 5%

* Significance at 1%

Table 3b: Regression between Firm Value and Corporate Governance variable

Dependent Variable: Firm Value (Tobin's Q)				
Variables	Coefficient	Std. Error	t-Statistic	Prob.
Board Indep	-0.523189	0.608468	-0.859846	0.3900
Board Size	0.047169	0.026086	1.808244	0.0708***
Insider	6.190068	4.810871	1.286684	0.1985
Insider ²	-7.352322	5.704465	-1.288871	0.1977
Instblock	-0.783925	0.306792	-2.555234	0.0107*
Non-Instblock	-0.598655	0.327838	-1.826069	0.0681**
CAPEX/TA	-0.628814	0.640546	-0.981683	0.3265
LogTA	1640.722	82.88624	19.79487	0.0000*
TANA/TA	1.183374	0.109152	10.84157	0.0000*
TL/TA	-0.001962	0.009095	-0.215706	0.8293
SD	0.282134	0.637765	0.442378	0.6583

Source: Processed Data by Eviews

Note:

*** Significance at 10%

** Significance at 5%

* Significance at 1%

Tables 3a and 3b illustrate the coefficients between variables in this study as a result of panel data regression. For Table 3a the fixed effect estimation model was used and for Table 3b, the random effect estimation model. Through Table 3a it can be seen that variables of corporate governance such as independent board (independent commissioners), board size, managerial ownership (insider and insider²) and institutional ownership (inst block) influence the cost of capital. For the first variable, the independent board has a significant influence and positive effect on cost of capital, which is in line with research conducted by Pham, Suchard and Zein (2012), although there is a little difference. The difference is the negative relationship of the independent board to the cost of capital in Pham, Suchard and Zein's (2012) research, while in this study it has a positive influence, which means that each percentage increase from the independent board will also affect the increase of the cost of capital. This result is also in line with research by Singhal (2014) and Nugroho (2016). In this research, it can be said that the greater the percentage of independent commissioners, the greater the cost of capital in a company. Independent commissioners have a role in maintaining the balance of the company in several ways, such as formulating strategies and making policies, supervising the directors and accountability, and complying with existing regulations. In this study, it should be referred to, as management is said to be good when the percentage of independent commissioners is above 30% (according to the rules of the Indonesian Stock Exchange) and

then followed by a decreasing cost of capital. However, if it refers to the results of the study, then, in this case, the percentage of large independent commissioner can not be directly linked with the company having good management, especially in the management of funds.

Second, board size has a significant influence and positively affects the cost of capital. The results of this study are in line with research conducted by Ganzeboom (2014) and Ferreira (2012), where increasing board size will be followed by an increase in the cost of capital. These results are closely related to the agency theory proposed by Jensen (1986). The results of this study are also consistent with the theory of resource dependence, whereby an increasingly larger board size signifies that the ability to obtain outside funding is even greater in order to increase the value of the firm (Sheikh and Wang, 2012). Abhor (2007) also says that the greater the number of boards of directors would lead to wider oversight, and that the board also has the authority to make decisions primarily in corporate funding and also should raise company value. The company's funding policy through debt has a lower risk than issuing shares, and also prevents a moral hazard.

Third, managerial ownership also has a significant effect on the cost of capital, and this result is also in line with research conducted by Pham, Suchard and Zein (2012). However, there are slight differences where the insider variable is positively related to the cost of capital, whereas the relationship of the insider² is negative. The existence of such positive relationships may be due to an entrenchment effect, whereby, based on this, high managerial ownership will affect the rising cost of capital (Slutz (1980) in Chen, Guo & Mande (2003)). Meanwhile, a negative relationship to the cost of capital makes sense; where the greater ownership is owned by the managerial, the smaller the cost of capital because the manager will control the risks that occur in the company. One of the manager controls is reducing the cost of debt that is one component of the cost capital (Rozaliny & Eko, 2014).

Fourth, institutional ownership has a significant influence and positive effect on the costs of capital, following research conducted by Pham, Suchard and Zein (2012). These results indicate that when the ownership of an agency grows larger, the smaller the cost of capital and vice versa. The presence of institutional ownership influences the supervising or controlling of management in a company. The greater the ownership of an agency, the more effective the supervision that will be given to the company.

Then, through Table 3b, it can be seen that variables of corporate governance such as board size, institutional ownership (inst block) and non-institutional ownership (non-inst block) influence firm value (Tobin's Q). Board size has a significant and positive influence on Tobin's Q, results which are in line with research conducted by Coleman and Biekpe (2005). Based on these results, it can be said that the greater the level of the board size, the higher the value of Tobin's Q. Furthermore, there are other studies in line with the results of this study,

such as research conducted by Novia and Lukviarman (2006) and Nugroho (2016). The Board of Directors (BOD) has an important contribution within a company, not only as a functional part of the control mechanism within a company, but also in participating in building a strategy for the company, and its implementation, decision-making process, giving rules to each of its members to cooperate in improving its performance in directing the company, and so on. When viewed from the results of the research, the results show that the greater the level of the board size, the more the value of Tobin's Q. It might also correspond with the agency theory, which states that the larger board size will make the supervision of management more effective, and have the potential to have produce greater experience and knowledge and provide better advice for the company's progress, thus resulting in higher corporate performance (Jensen and Meckling, 1976). As the company progresses and produces high performance, it can also increase the value of the company.

Institutional ownership in this study has results in line with Fehr (2015), where the greater the ownership of the institution, the less the value of a company. This result happens because when the institutional ownership of a company is large enough, the investor of the owner also has considerable rights and power in determining decisions for the company, and often those rights and powers are misused to their advantage. Given that, large institutional ownership tends to minimise firm value due to investor indifference to maximising corporate value and welfare from other shareholders (Bhattacharya & Graham (2007), Gugler & Weigand (2003) and Chaganti & Damanpour (1991) in Fehr (2015)).

The non-institutional ownership in this study has a negative effect on the company's value. This result has the sense that the growing non-institutional ownership makes the company's value smaller, and vice versa. This result is in line with research conducted by Mustapha and Ahmad (2013), wherein the ownership of non-institutional shares has a negative relationship with monitoring costs. In contrast, a percentage of non-institutional shareholdings increase. This will reduce monitoring costs. The negative relationship is due to the small number of non-institutional ownership in the research companies, which is only 18% when compared to institutional ownership. Investors from institutional ownership can collude with the management of the company to take over the rights of the stock investor with minority ownership (in which case the minority interest in question is non-institutional ownership). The incident has a positive effect on raising capital costs and when capital costs are too high, they are not necessarily able to raise the value of a company.

Conclusion

This research concludes that corporate governance has an effect on the cost of capital, indicated by the increase in proportion of independent commissioners, the increase in the number of boards of directors and the increase in commissioners. Managerial ownership also



has a positive effect with cost of capital, due to the entrenchment effect and insider, which have a negative relationship with the cost of capital due to the control of management to minimise the cost of capital, and greater institutional ownership, followed by the increasingly small cost of capital. Furthermore, this study also shows that corporate governance influences corporate value. The study found that some of the variables of corporate governance influence firm value. This study has the same results as the research of Pham, Suchard and Zein (2012), although there is a slight difference in the effect on the cost of capital. However, when it is viewed from its influence on corporate value, this study has different results to those of prior research. Based on the results of this study, two points need to be considered by a company, such as: (i) the number of the board of commissioners, whether it is too excessive because if the amount is too large, it can increase the cost of capital; (ii) institutional ownership also needs to be considered, whether the proportion is excessive or not, because if it is too excessive, it will reduce the value of the company.

For further research, it is helpful if variables of the corporate governance mechanism in this study can be added, such as foreign ownership, the composition of the audit committee, the number of board meetings and so forth, to shed new light and strengthen the results of the study.

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