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## The effect of corporate governance on the capital structure : an Indonesian case

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## Abstract

The purpose of the research was to analyze the effect of Corporate Governance on the Company's Capital Structure. The variable used in this study were director size, outside commissioner, director ownership, institutional investor, audit quality, CEO tenure, size, growth, profitability, and intangible asset. This research used a quantitative approach with multiple linear regression analysis model. This research used samples taken from non-financial sector companies listed on the Indonesia Stock Exchange (BEI) in 2011-2015. The number of samples used in this research was 300 observations. It was found that the whole variables were significant at the level of 5% except for growth variable and intangible asset was significant at the level of 10%.

## Keywords

Author Keywords: corporate governance; capital structure; outsider commissioner; institutional investor; intangible asset

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# The effect of corporate governance on the capital structure : an Indonesian case

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**ABSTRACT:** The purpose of the research was to analyze the effect of Corporate Governance on the Company's Capital Structure. The variable used in this study were director size, outside commissioner, director ownership, institutional investor, audit quality, CEO tenure, size, growth, profitability, and intangible asset. This research used a quantitative approach with multiple linear regression analysis model. This research used samples taken from non-financial sector companies listed on the Indonesia Stock Exchange (BEI) in 2011-2015. The number of samples used in this research was 300 observations. It was found that the whole variables were significant at the level of 5% except for growth variable and intangible asset was significant at the level of 10%.

**Keywords:** corporate governance, capital structure, outsider commissioner, institutional investor, intangible asset

## 1 INTRODUCTION

As AEC (ASEAN Economic Community) has been enacted, companies in Indonesia are facing a more difficult competition. Therefore, financial stability is one of the main strengths in seizing the opportunity and avoiding external environmental threats. In this case, efficient corporate governance mechanism will cause the reduction of debts which eventually reduce the risk of financial stability in the company (Dimitropoulos 2014). Therefore, corporate governance mechanism is required for managing the capital structure of the company optimally so that the balance between risk and the return of debt and capital composition can be achieved. An optimal composition will lead the company to achieve its objective which is to maximize the company's value.

The research on capital structure is conducted in order to achieve the best combination of the best capital structure in a company. A non-optimal capital structure will increase company cost that eventually suppresses the profit of the company.

Sheikh & Wang (2012) stated that director size has a positive effect on debt ratio. In other words, the more board members of a company, the bigger the debt composition applied.

Dimitropoulos (2014) stated that outside commissioner has a negative effect on debt ratio. The bigger the number of the board member from outside the company, the lower the composition of the debt towards the equity. Dimitropoulos (2014) stated that the existence of the independent commissioner in the board will lead to the lower use of leverage because of the strict supervision and control, so the agency conflict between the directors and the stakeholders can be avoided. In line with the condition, Dimitropoulos (2014) stated that the application of corporate governance practice (such as independent board) may be an important mechanism to manage the organization based on transparency, accountability, and justice principals, so that exposure on leverage may be limited.

The research conducted by Hasan & Butt (2009) found that there is a negative effect of managerial ownership on debt ratio. It suggests that the bigger the ownership of the management (board of directors), the lower the debt composition in the company. It may be caused by the idea that the higher the debt composition in the company, the bigger the risk of default. This condition is in conflict with the managerial interest in the long-term sustainability of the company.

The research conducted by Hussainey & Aljifri (2012) shows that there is a negative effect of an institutional investor on debt ratio. In this case, the higher the ownership of the institutional investor, the greater the use of debt in the company. The institutional investor functions as an effective tool to monitor the corporate strategic decision, lower the agency cost, and reduce the chance of arbitrary action of the board of directors (Hasan & Butt 2009). Having the supervision of the institutional investor, the confidence of the public and other creditors may grow, and it can be easier for the company to get a loan.

Chang et al. (2009) show that audit quality has a negative effect on debt. It means that the better the audit quality, the lower the use of debt in the company. A company with a higher external audit quality (audited by the big-4) reported that there was an improvement in the quality of the financial report marked by the decreasing information asymmetry which in turn may decrease the equity cost. As a result, the company would prefer to use equity funding to debt.

According to Dimitropoulos (2014), CEO tenure has a positive effect on debt ratio. It means that the longer the CEO (Chief Executive Officer) holds his position, the more the amount of the company debt. In his research, CEO tenure was used as the instrument of CEO duality. According to Baatwah (2015), a CEO with a long tenure has a better and active accounting skill in improving the strategic decision and a better company's financial report. As a result, the company with a better financial report will be easier in getting a loan from the bank because the bank believes that the company will be able to settle loan principal as well as the interest.

According to Dimitropoulos (2014) and Hussainey & Aljifri (2012), size has a positive effect on debt ratio. The bigger the size of the company, the higher the debt composition. This was also proven by James (1987) and Ojah & Manrique (2005) in Dimitropoulos (2014) which shows that major companies have a higher quality project in their portfolio, so they tend to fund the projects through bank loans in order to avoid the spread of information to their competitors. A big company may also experience overinvestment where the manager tries to fund the projects through loans. Besides, Chang et al. (2006) in Dimitropoulos (2014) shows that bigger companies, in general, have a higher risk than their smaller partners, and they are likely to issue debt instead of equity.

According to Oino & Ukaegbu (2015), growth has a significant positive effect on debt. It means that the faster the company grows, the bigger the debt composition compared to the equity possessed. Um (2001) in Murhadi (2011) also stated that a

growing business suffers pressure in funding investment opportunities if the investment is higher than the retained profit. In other words, a growing company has the tendency to use debt because the retained profit is insufficient in funding the investment opportunities.

According to Dimitropoulos (2014) and Sheikh & Wang (2012), profitability has a negative effect on debt ratio. It means that the more profitable the company, the lower the use of debt in the company. A company with a high profit tends to use the retained profit as the source of funding. If the internal funding is sufficient, the company does not have to apply for external funding.

According to Dimitropoulos (2014), intangible asset has a positive effect on debt ratio. It means that the bigger the intangible asset in a company, the higher the use of debt on the equity.

Based on the explanation above, this research was focused on observing the effect of corporate governance on capital structure.

## 2 RESEARCH METHODS

This research was conducted to test the effect of Corporate Governance measured using independent variables (director size, outside commissioner, managerial ownership, institutional investor, audit quality, and CEO tenure) and control variables (size, growth, profitability, and intangible asset) towards the capital structure which were measured using dependent variable (debt ratio) in the non-financial sector businesses listed on the Indonesia Stock Exchange (BEI) in 2011 – 2015.

The dependent variable in this research was the debt ratio which was measured through the total of the debt divided by the total asset. Meanwhile, the independent variable of director size was measured by the number of board of directors. The outside commissioner was measured by the number of the independent commissioners. The managerial ownership was measured by the proportion of the stock held by the directors. The institutional investor was measured by the proportion of the stock held by the institutional investor. The audit quality was measured by the result of the audit "1" by the Big-4 and "0" by the others. The CEO tenure was measured by the duration of the position as the CEO.

The control variables like the size, which was measured by natural logarithm of the total asset, and growth which was measured by the net income this year divided by the net income in the t year divided by the t-1 year. While the profitability was measured by the net income divided by the total asset. Finally,

the intangible asset was measured by the intangible asset divided by the total asset.

### 3 RESULTS AND DISCUSSIONS

The following regression test result table shows the results of the research:

Table 1. Regression test result

Variable	Coefficient	t-Statistic
C	-1.726891	-22.98275
DIR_SIZE	-0.022018	-11.23014***
OUT_COM	-0.032543	-4.665371***
MAN_OWN	0.540747	15.17841***
INST_OWN	0.331755	21.09926***
AUD	-0.055943	-10.88901***
TENURE	0.001413	4.751806***
SIZE	0.075902	28.35210***
GROWTH	0.038599	1.935447*
PROF	-0.569181	-10.97940***
INT_ASSET	0.044004	1.654976*

Notes: \* : significance at 10%  
 \*\* : significance at 5%  
 \*\*\* : significance at 1%

Table 1 shows that the variable is significant at 5% level, except for the growth variable, and the intangible asset is significant at 10% level.

The director size variable has a significant negative relationship with the debt ratio. It is because the directors prefer lower debts than optimal debts (as low as possible) as the directors want to lower the corporate risk. Besides, the directors are not apt to pressure. If the directors have more debts, there will be more parties monitoring their performance. Hence, many directors prefer less debt in the companies (Berger et al. 1997).

Outside commissioner has a significant negative relationship with the debt ratio. It is because the existence of independent commissioner in the board will lead to the low use of leverage because of the strict supervision and control, so the agency conflict between the directors and stakeholders can be avoided (Dimitropoulos 2014).

Managerial ownership variable has a significant positive relationship with the debt ratio. It is because the director acts as the shareholders who will try to improve the value of the company because the director has the same interest as the shareholders. Therefore, the possibility of agency problem is smaller and a bank will be more confident in granting loans. In addition, the director will prefer to fund the new investments through loans instead of equity (Dimitropoulos 2014).

The institutional ownership variable had a significant positive relationship with the debt ratio. It is because of the supervision of the institutional investor, the confidence of the public and other creditors

may grow, and it can be easier for the company to get a loan (Hasan & Butt 2009).

The audit quality variable had a significant negative relationship with the debt ratio. It is because a company with a higher external audit quality (audited by the Big-4) reported that there was an improvement in the quality of the financial report marked by the decreasing information asymmetry which in turn may decrease the equity cost. As a result, the company would prefer to use equity funding to debt (Chang et al. 2009).

The CEO tenure variable had a significant positive relationship with the debt ratio. It is because the CEO with a long tenure has a better and active accounting skill in improving the strategic decision and a better company's financial report. As a result, the company with a better financial report will be easier in getting a loan from the bank because the bank believes that the company will be able to settle loan principal as well as the interest (Baatwah 2015).

The size variable shows a significant positive relationship with the debt ratio. It is because major companies have a higher quality project in their portfolio, so they tend to fund the projects through bank loans in order to avoid the spread of information to their competitors (Dimitropoulos 2014).

The growth variable had a significant positive relationship with the debt ratio. It is because that a growing business suffers pressure in funding investment opportunities if the investment is higher than the retained profit. In other words, a growing company has the tendency to use debt because the retained profit is insufficient in funding the investment opportunities (Murhadi, 2011).

The profitability variable had a significant negative relationship with the debt ratio. It is because a company with a high profit tends to use the retained profit as the source of funding (pecking order theory).

The intangible asset variable had a significant positive relationship with the debt ratio. It is because a company that holds the brand with good reputation (intangible asset) will get loans easier from banks because they believe in the capability of the companies in settling the debt (Benkraiem et al. 2011)

### 4 CONCLUSION

Based on the research, it was found that all variables were significant at 5% level, except for growth and intangible asset which were significant at 10% level. The researchers hope that this research can give the illustration for the companies in terms of the effect of the governance towards the corporate capital structure in which an optimal capital structure com-



bination may affect the decrease of cost and expenses of the company. Companies (especially in Indonesia) may take this research into consideration in making a decision on the capital structure selection.

For the investors, this research is expected to give an illustration of the effect of corporate governance on the company's capital structure. A healthy company shows good governance. Investors may take this research into consideration of the issues related to the factors of corporate governance (director size, outside commissioner, managerial ownership, institutional investor, audit quality, CEO tenure, size, growth, profitability, and intangible asset) before investing on the stocks of the companies in Indonesia.

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