Does Corporate Governance Affect Firm Value? Evidence from Indonesia Banking Sector

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Abstract

Increasing the value of the company, followed by increasing the company's share price would provide the advantage of capital gains for investors. This shows the level of investor confidence in a company to manage their funds will affect the company's stock price movement of capital market, because buying stocks is to instill confidence in the management of a company to manage their funds. The objective of this research is determinants of firm value in banking companies listed in Indonesia Stock Exchange are Examined context with reference to firm value theories. The population consists of 22 banks. The period under study is from 2007 to 2012 the data are taken from the banks' annual reports. In this study using panel data and analysis using pooled ordinary least squares (OLS). The results are ROA and Log Asset have no effect on banks value. Managerial ownership negative effect on banks value. The results of the study do not support agency theory to minimize the agency conflict is to increase managerial ownership in the company. Investment opportunity positive effect on banks value

Key Words *: firm value,* Managerial ownership and banking

1. Introduction

Increasing the value of the company, followed by increasing the company's stock price will provide the advantage of capital gains for investors. This shows the level of investor confidence in a company to manage their funds will affect the company's stock price movement of capital markets, as buying stocks is to instill confidence in the management of a company to manage their funds.

Implementation of the principles of good corporate governance will be more effective if carried out by the independent board, so as to reflect that the company is well managed and transparent. Many countries have strengthened recommendations on board composition and independence (Aguilera, 2005; Huse, 2005). As amatter of fact, a recent study shows that nowadays the independence of non-executive directors is a commonly recommended governance practice (Zattoni and Cuomo, 2010). However, in banking researches, the results regarding the effectiveness of outside directors aremixed. Some empirical researches in the last decades show no significant relationship between board composition, considered as the proportion of outsiders or of independent board members onthe board, and banks performance (Romano *et al.*, 2012; Adams and Mehran, 2008; Love and Rachinsky, 2007; Zulkafli and Samad, 2007; Adams and Mehran, 2005; Simpson and Gleason,1999; Pi and Timme, 1993).

Ownership of the company is one of the ways that can be used so that managers perform activities in accordance with the interests of the owner of the company. According to agency theory, the separation between ownership and management of the company can lead to conflict. The impact of this agency problem is the emergence of distrust of investors and shareholders for management's ability to manage the company to generate profits for investors. Distrust of shareholders against the management will reduce the value of the company in the future.

Investment opportunity set (IOS) in a company can determine whether a company will be able or not able to make a profit. IOS high indicates that the company is also investing in the future high, so investors interested in investing and impact on rising stock prices. Higher stock prices will boost the company's value of investors.

The study will to fill this gap by determining which factors have significant effect on firm value decision of banking sector of Indonesia during 2007 to 2012.

2. Literature Review

Board composition is a debated corporate governance issue since it could influence board deliberations and the capability to control top management decisions and results. Although there is not an optimal formula (Vance, 1978), board independence has became a relevant issue in the corporate governance agenda. As a matter of fact, non-executive and independent directors are considered one of the most important mechanisms for ensuring corporate accountability (Daily *et al.*, 2003; Dalton *et al.*, 1998).

A number of studies in the past, which aimed at establishing the effect of outside directors on the success or failure of firms, have examined the board composition and its impact on firm performance (Barnhart, Marr & Rosenstein 1994; Beasley 1996; Byrd & Hickman 1992; Daily & Dalton 1992; Fosberg 1989; Hermalin & Weisbach 1991; Schellenger, Wood & Tashakori 1989). However, empirical evidence on outside independent directors and firm performance is mixed, as there are some studies which found a majority of outside independent directors improved performance (Barnhart, Marr & Rosenstein 1994; Daily & Dalton 1992; Schellenger, Wood & Tashakori 1989),

He et al. (2009) state that board independence is the most effective deterrent of fraudulent financial reporting. As a matter of fact, many studies (Dechow et al., 1996; Beasley, 1996; Beasley et al., 2000; Song and Windram, 2004; Uzun et al., 2004; Farber, 2005) showed that firms committing financial reporting fraud are more likely to have a board of directors dominated by insiders. With reference to Italy, Romano and Guerrini (2012) find that the higher the percentage of independent directors on the board, the lower the likelihood of financial fraud, arguing that a higher relative weight of independent directors appears to ensure more effective control.

However, the majority of the existing studies about banks shows a significantly positive relationship between board composition and banks' profitability or efficiency, highlighting how banks with a higher presence of non-executives or independent members in their boards perform better than the others (Shelash Al-Hawary, 2011; Trabelsi, 2010; De Andres and Vallelado, 2008; Tanna et al., 2008; Bino and Tomar, 2007; Busta, 2007; Pathan et al., 2007; Staikouras et al., 2007; Sierra et al., 2006; Isik and Hassan, 2002). Moreover, Brewer et al. (2000) find that the bid premiums offered for target banks increase with the proportion of independent outside directors.

Our last group of variables consists of variables related to director interlocks and CEO and director compensation. Hallock (1997) argues that interlocks may be representative of a dual agency problem. On the other hand, authors in the organizational literature arguethat interlocks are beneficial since they may reduce the information uncertainty created byresource dependence amongst firms (e.g. Pettigrew, 1992). While the predicted sign of the correlation between performance and interlocks is unclear, it is plausible that a correlation exists. There is also a vast literature that argues that the percentage of CEO ownerships correlated with Tobin's Q (e.g. Morck, Shleifer, Vishny, 1988; McConnell and Servaes, 1990). Some studies have found a positive relation between CEO shareholdings and both Tobin's Q and ROA (e.g. Mehran, 1995).

The size of a company measured by market capitalization represents the total value of a company. Market capitalization is a market estimate of the value of a company, based on perceived future prospects, and economic and monetary conditions. It is calculated by multiplying the current price per share by the total number of outstanding shares. Investor confidence is reflected in the market capitalization.

Investment in companies with higher market capitalization has lower risk compared to the firms with lower market capitalizations, because shares of firms with higher market capitalization are more liquid. Alternatively firms with lower market capitalization may be profitable due to a higher growth potential. The risk factor attached to shares of companies with lower market capitalization may be high, even though they have higher financial returns (Rashid 2007). Prior empirical studies find that firm performance is positively related to market capitalization (Yarmack 1996, Hasnawati 2005)

3. Method

The population consists of 102 banks which are 5 government banks, 71 private banks and 26 community development banks. The sample consists of 22 banks in Indonesia stock Exchange (IDX). The period of this study is from 2007 to 2012. The data are taken from banks' annual reports. In this study using panel data and using pooled ordinary least square (OLS), random effect and fixed effect analysis. The following model is estimated:

$$Y= a + b_1X_1 + b_2X_2+b_3X_{3+} b_4X_{4+} b_5X_{5+} + e_{it}$$

Where

Y = Banks Value

X_1 = The proportion of independent board

X_2 = Managerial ownership

X_3 = Market to book value of equity(Investment opportunity)

X_4 = Return on Assets (ROA)

X_5 = Log Assets

e_{it} : error term of bank *i* in period *t*.

4. Result and Discussion

Tabel 1
Descriptive Statistics

	TobinsQ	independent board	Managerial ownership	IOS	LN assets	ROA
TobinsQ	1.0000					
independent board	0.0048	1.0000				
Managerial ownership	-0.0325	0.0790	1.0000			

IOS	0.8861	-0.0377	0.0598	1.0000		
LN asseta	0.4035	0.1351	-0.2840	0.4017	1.0000	
ROA	0.1446	0.2953	-0.0336	0.1004	0.1048	1.0000

Table 1 provides information on the degree of correlation between the explanatory variables used in the multivariate regression analysis. The matrix shows that in general the correlation between the variable that are used in the analysis is not strong suggesting that multicollinearity problem are either not severe or non-existent. Kennedy (2008) and Gujarati (2009) points out that multicollinearity is a problem when the correlation is above 0.8, which is not the case here. To ensure that there is no problem of multicollinearity, variance inflation factor (VIF) are estimated and since the results show that the VIF are below 10.

The results showed that the variable data processing managerial ownership and investment opportunities affect the bank values, while independent board has no effect on the bank values. This is due to that the banking activity is closely monitored by the Bank of Indonesia so that the director cannot make policy contradicts with Bank Indonesia regulation. The results of the study consist by Fosberg 1989; Hermalin and Weisbach 1991; Molz, 1988.)

Table 2
Regression with Random Effect and Fixed Effect
Dependent Variable: *Tobin'Q*

Variable	Random Effect		Fixed Effect	
	Coef.	p-value	Coef.	p-value

proportion of independent board	.0035145	0.930	-.0036739	0.937
Managerial ownership	-.0007594	0.130	-.0012953	0.084
Investment opportunity	.0753711	0.000	.070587	0.000
LN Assets	.0027049	0.589	-.0134021	0.400
ROA	.0009728	0.427	.0007654	0.545
Constant	.9006295	0.000	1.190636	0.000
R-squared	0.7955		0.7540	
Prob > F	0.0000		0.0000	
Number observation	132		132	

The negative and significant coefficient on managerial ownership is somewhat surprising given that previous papers find no relation between ownership and Tobin's Q (see Himmelberg, Hubbard and Palia, 1999; Palia, 2001). The results of this study indicate that managerial ownership can decrease the value of the company as the manager's decision to have a large stock can be detrimental to the bank. Thus the market is responding negatively to the stake in the bank manager.

The results of the study do not support agency theory to minimize the agency conflict is to increase managerial ownership in the company. Managerial ownership is believed to influence the course of the company to achieve its goals, which maximize the value of the company. Ownership in the company managers make managers work hard. If managers do not manage the company well, then the company will not achieve its objectives so that the lower the value of the company. Conversely, if the managers manage the company well, then the value of the company will increase which means it will provide benefits for shareholders and corporate managers. With the managerial ownership, managers participate directly feel the benefits of the decisions taken and were also bear the loss as a consequence of making the wrong decision.

The results showed that the investment opportunity (IOS) was significantly positively on firm value. These results together with the Yarmack 1996), Hasnawati (2005). This shows that the investment decision is important, because in order to achieve the company's objectives will only be generated through investment activities of the company. IOS has a very important role for the company, because IOS is an investment decision in the form of a combination of owned assets and investment options that will come, where the IOS will affect the value of a company. IOS describe the breadth of opportunities lending by banks.

5. Conclusion

The population consists of 102 banks which are 5 government banks, 71 private banks and 26 community development banks. The sample consists of 22 banks in Indonesia stock Exchange (IDX). The period of this study is from 2007 to 2012. Our study uncovers interesting results. We find that the results showed that the variable data processing managerial ownership and investment opportunities affect the bank values, while independent board has no effect on the bank values. This is due to that the banking activity is closely monitored by the Bank of Indonesia so that the director cannot make policy contradicts with Bank Indonesia regulation. Managerial ownership can decrease the value of the company as the manager's decision to have a large stock can be detrimental to the bank. Thus the market is responding negatively to the stake in the bank manager. The results are ROA and Log Asset has no effect on banks value

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