Journal of Economics, Finance and Management Studies
ISSN (print): 2644-0490, ISSN (online): 2644-0504
Volume 06 Issue 05 May 2023
Article DOI: 10.47191/jefms/v6-i5-48, Impact Factor: 7.144
Page No. 2284-2290

Corporate Governance, Ownership Structure, and Firm Value: Evidence from Indonesia

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ABSTRACT: Firm value is crucial for every company, but agency problems that arise due to conflicts of interest between managers and shareholders can reduce the value of a company. Based on agency theory, one mechanism to reduce agency problems is the implementation of good corporate governance and ownership structures. Therefore, this study aims to predict whether there is an influence between corporate governance and ownership structure on firm value. This research was conducted on companies in the LQ45 index during the 2020-2022 period. Researchers obtained 87 units of analysis which were then analyzed using structural equation modeling (SEM). This study's results are corporate governance has a positive and significant effect on firm value. However, ownership structure does not affect firm value. Future studies can use different samples, extend the observation period, use other indicators to measure each variable, and use a broader framework.

KEYWORDS: Corporate Governance, Ownership Structure, Firm Value, Indonesia

I. INTRODUCTION

The separation between ownership and control in a company creates agency problems (Jensen & Meckling, 1976). Managers who are routinely directly involved in company operations have many in-depth information compared to shareholders, which causes shareholders cannot observe managers (Siagian et al., 2013). This information asymmetry creates problems if managers's objective are not in line with those of shareholders. There is a potential moral hazard problem where managers tend to prioritize personal interests at the expense of shareholders' interests. This information asymmetry also causes shareholders to be unable to evaluate the actual performance of managers.

Corporate governance represents a set of mechanisms that function to reduce agency risk that arises due to information asymmetry (Ashbaugh et al., 2004). In addition, corporate governance can become a mechanism that forces managers to disclose important information so that information asymmetry between managers and shareholders can be minimized (Siagian et al., 2013). Corporate governance is also able to increase the timeliness of disclosure of financial information, help prevent accounting fraud, increase reporting transparency, and entrust responsibility to top management in cases of non-compliance (Balachandran & Faff, 2015).

Aspects of corporate governance are adopted from the agency theory of Jensen & Meckling (1976) as a basis for creating a balance between the interests of management, shareholders, and stakeholders. Based on the perspective of agency theory, the purpose of corporate governance is to convince company shareholders that managers are carrying out their duties, namely to maximize shareholders' wealth (Shleifer & Vishny, 1997). Companies that practies good corporate governance will have fewer agency problems (Siagian et al., 2013). Conversely, companies that have a weak corporate governance structure tend to have poor performance due to agency conflicts (Bhat et al., 2018).

Good corporate governance is one of the keys to a company's success to continue to grow, generate long-term profits, and win the business competition (Suhadak et al., 2019). Asbaugh et al. (2004) stated that corporate governance allows for better supervision and control so that managers tend to make decisions in the interests of shareholders such as investing in projects with a positive NPV. Corporate governance also increases the protection of shareholders by minimizing the opportunistic behavior of managers which can reduce firm value (Siagian et al., 2013). Therefore, companies that implement corporate governance tend to have higher firm values.

Corporate governance practices can increase value (Johl et al., 2016) and companies with an effective governance system can increase their firm value by reducing conflicts of interest between minority shareholders and managers, as well as reducing information asymmetry and increasing managerial efficiency (Nazir & Afza, 2018). Companies that have good corporate governance practices can have excellent performance compared to their competitors for two reasons. First, companies with better governance use their funds and resources efficiently to generate profitable investments. Investors feel safe when investing their money in these companies because they believe that the costs incurred to mitigate risk are lower and expect higher returns which ultimately lead to an increase in stock prices and firm value (Jensen & Meckling, 1976). Second, companies with good corporate governance tend to require lower cost of equity capital because the costs incurred to supervise managers and audit financial statements are lower (Shleifer & Vishny, 1997).

The ownership structure is also one of the key elements in determining how the interests of shareholders are protected from various exploitations that can be carried out by managers (Ali et al., 2018). Ownership structure refers to the proportion of company shares owned by the largest number of shareholders (Fatma & Chouaibi, 2021). The ownership structure can help mitigate agency problems between managers and shareholders because large shareholders are better able to control the actions of managers compared to majority shareholders (Shleifer & Vishny, 1997; Ali et al., 2018). The ownership structure can increase firm value (Asante-Darko et al., 2018; Nazir & Afza, 2018; Rehman et al., 2020; Vintilă & Gherghina, 2013). The ownership structure implies an increase in the capacity of major shareholders to control managers which leads to compatibility of goals between managers and shareholders in increasing firm value (Fatma & Chouaibi, 2021).

Several previous studies have tested the effect of corporate governance and ownership structure on firm value, but the results of these studies are still contradictory and have not been able to clearly explain the influence of these variables. Suhadak et al. (2019) obtained results that good corporate governance was able to increase firm value, while the results of Lehn et al. (2007) stated that corporate governance does not affect firm value. Therefore, this study aims to determine whether corporate governance and ownership structure can affect firm value in companies in Indonesia.

II. LITERATURE REVIEW AND HYPOTHESIS DEVELOPMENT

Agency Theory

Agency theory is a theory proposed by Jensen & Meckling (1976) which is based on conflicts of interest between various parties entering into contracts – namely shareholders, company managers, and creditors. Jensen & Meckling defines an agency relationship as a contract in which one party (principal) gives another party (agent) decision-making authority to perform activities on its behalf. Agency problems arise because of the separation between decision-making carried out by managers and risks borne by shareholders (Asante-Darko, 2017). Managers who are routinely directly involved in company operations have a lot of in-depth information compared to shareholders, which causes shareholders cannot observe managers (Siagian et al., 2013).

This information asymmetry creates agency problems if the manager's goals are not in line with the wishes of the shareholders. There is a potential moral hazard problem where managers tend to prioritize personal interests at the expense of shareholders' interests (Siagian et al., 2013). Management tends to prioritize their interests at the expense of shareholders, which makes management prefer activities that do not add value to the company (Asante-Darko, 2017). This information asymmetry creates a cost known as agency cost. Agency costs are costs that incurred to provide managers with appropriate incentives to act in the best interests of shareholders, where the company imposes these costs on shareholders.

Firm Value

Firm value is an investor's perception of a company that is very closely related to the stock market price (Fatma & Chouaibi, 2021). The main goal of the company is to maximize firm value, which determines the level of prosperity of shareholders. Referring to Ibrahim (2020), share prices can be interpreted as a company's market value that can prosper shareholders, so that an increase in the company's share price will increase the welfare of shareholders (Fatma & Chouaibi, 2021). In other words, maximizing firm value is very important because it means maximizing the prosperity of shareholders which is the main goal of the company.

Corporate Governance

Corporate governance is a set of mechanisms used to reduce agency risk arising from information asymmetry (Ashbaugh et al., 2004, Siagian et al., 2013). Corporate governance aspects are adopted from agency theory as a basis for creating a balance between the interests of management, shareholders, and stakeholders (Suhadak et al., 2019). The purpose of corporate governance is to ensure that managers will act in the interests of shareholders (Siagian et al., 2013). In addition, corporate governance mechanisms can force managers to disclose important information so that information asymmetry between managers and shareholders can be minimized.

Corporate governance allows for better supervision and control so that managers will tend to make decisions in the best interests of shareholders such as selecting investment projects with positive NPV (Siagian et al., 2013). Corporate governance ensures the accountability of top management by simultaneously giving executives autonomy and incentives to exploit business opportunities that generate profits (Braswell & Daniels, 2017). Corporate governance is also able to protect shareholders by minimizing the opportunistic behavior of managers which can reduce company value (Siagian et al., 2013). Therefore, companies that implement corporate governance tend to have higher firm values.

Companies with higher firm values or stronger shareholders' rights are easy to see in companies with better corporate governance practices compared to companies with relatively poor corporate governance (Chen et al., 2010). Companies with weaker quality governance practices can ultimately destroy shareholder value, which is the result of inefficient investment decisions. In other words, companies with good governance practices are better able to mitigate conflicts of interest between shareholders and managers, thereby reducing agency costs (Dittmar & Mahrt-Smith, 2007; Masulis et al., 2007). Beiner et al. (2006) stated that the direct influence of corporate governance on firm value lies in its role in reducing agency costs by eliminating uncertainty related to future cash flows, thereby reducing the cost of capital. Therefore, this study proposes the following hypothesis:

H1: Corporate governance has a significant effect on firm value

Ownership Structure

Ownership structure refers to the proportion of company shares owned by the largest shareholders (Fatma & Chouaibi, 2021). The ownership structure is a key element in the company to determine how to protect the interests of shareholders from various potential exploitations that can be carried out by managers (Ali et a., 2018). Ownership structure can help mitigate agency problems between managers and shareholders because large investors are better able to control the actions of managers than small owners (Shleifer & Vishny, 1997). Companies with a good ownership structure have strong analytical skills and the power to act as a pressure group to oversee and even guide management actions and behavior (Ali et al., 2018).

Ownership structure plays an important role in increasing firm value because it can equate the interests of managers and shareholders (Nazir & Afza, 2018). The ownership structure gives rights and capabilities to shareholders to discipline and supervise management (Freihat et al., 2019). A good ownership structure is able to reduce the possibility that managers take actions or take investment projects that are detrimental to shareholders, which in turn will reduce firm value.

The relationship between ownership structure and firm values has become a topic that has been extensively studied in several previous studies. Alimehmeti & Paletta (2009), Rehman et al. (2020), and Vintila & Gherghina (2014) state that ownership structure has a positive effect on firm values. This positive relationship implies that an increase in supervisory capacity by major shareholders can lead to compatibility between the interests of managers and shareholders in increasing firm value (Fatma & Chouaibi, 2021). Therefore, this study proposes the following hypothesis:

H2: Ownership structure has a significant effect on firm value

III. METHOD

This research is an explanatory research with a quantitative approach. The research type was chosen to test the hypothesis in explaining the effect of exogenous variables - corporate governance and ownership structure on endogenous variables - firm value. Corporate governance is measured using board size (BS), board independence (BI), and board diversity (BD). Ownership structure is measured using ownership concentration (OC), institutional ownership (IO), and CEO ownership (C). Firm value is measured using return on assets (ROA), Tobin's Q (TQ), and earnings per share (EPS). The following table describes the operationalization of indicators.

Table 1. Variable Description

Variable	Indicators	Formula	References
Corporate Governance	BS	Total numbers of directors	Bhat et al. (2018), Fatma & Chouaibi (2021), Karim et al. (2022), Nazir & Afza (2018)
	BI	The proportion of independent directors to total numbers of directors	Bhat et al. (2018), Fatma & Chouaibi (2021), Karim et al. (2022), Nazir & Afza (2018)
	BD	The proportion of female directors to total numbers of directors	Karim et al. (2022)
Ownership Structure	OC	Percentage of shares owned by the ten largest shareholders to total number of shares issued	Ali et al. (2018), Fatma & Chouaibi (2021), Karim et al.

Variable	Indicators	Formula	References
			(2022)
	IO	Shares held by institutional investors to total outstanding common shares	Ali et al. (2018), Karim et al. (2022)
	CO	Percentage of shares owned by chief executive officer to total number of shares issued	Fatma & Chouaibi (2021)
Firm Value	ROA	Net income/total assets	Ali et al. (2018), Karim et al. (2022)
	TQ	(Market value of common stock + book value of total liabilities)/total assets	Ali et al. (2018), Bhat et al. (2018), Karim et al. (2022), Nazir & Afza (2018), Siagian et al. (2013)
	EPS	Net income to total outstanding common stock	Karim et al. (2022)

Source: Prior research

The data used in this study is secondary data in the form of financial reports and annual reports obtained from the Indonesia Stock Exchange (IDX). The object of research is a company that is included in the list of companies that have the highest stock liquidity (LQ45) during the 2020-2022 period. The sample was determined using purposive sampling, to obtain 29 companies with 87 firm-years data. The data analysis method used is descriptive statistical analysis and SEM-PLS using WarpPLS 7.0 software.

IV. RESULT

Descriptive Statistical Analysis

Descriptive statistical analysis is used to provide an overall picture of the research variables. This study uses the mean, standard deviation, maximum, and minimum value to provide an overview of the research variables. The results of the descriptive statistical analysis are shown in Table 2.

Table 2. Descriptive Statistical Analysis (87 firm-years data)

Indicator	Minimum	Maximum	Mean	Standard Deviation
BS	8.0000	22.0000	14.3103	4.0096
BI	0.0000	0.3333	0.1908	0.0735
BD	0.0000	0.4444	0.1264	0.1037
OC	50.0900	95.7000	64.9564	14.3025
IO	27.4900	95.7000	62.2783	15.3970
CO	0.0000	6.1800	0.2193	1.1331
ROA	0.0002	0.4543	0.0831	0.0843
TQ	0.5486	14.4147	1.7943	1.9923
EPS	1.4032	16,779.6726	765.3491	2,006.1567

Source: Processed data, 2023

Outer Model Evaluation

The outer model explains the relationship between indicators and latent variables. The outer model in this study is formative. If the probability value ≤ level of significance (Alpha (α) = 5%), then the indicator is declared valid. The results of the outer model evaluation are shown in Table 3.

Table 3. Formative Model Validity Evaluation

Variable	Indicators	Weight	SE	P-Value	Description
Corporate Governance	BS	0.191	0.101	0.031	Valid
	BI	0.653	0.089	<0.001	Valid
	BG	-0.574	0.091	<0.001	Valid
Ownership Structure	OC	0.495	0.093	<0.001	Valid

Variable	Indicators	Weight	SE	P-Value	Description
	IO	0.512	0.092	<0.001	Valid
	CO	-0.222	0.101	0.015	Valid
Firm Value	ROA	0.555	0.091	<0.001	Valid
	TQ	0.377	0.096	<0.001	Valid
	EPS	0.358	0.097	<0.001	Valid

Source: Result of data processing using WarpPLS 7.0

Inner Model Evaluation

Inner model evaluation explains the relationship between variables. Inner model evaluation is done by looking at the value of R2, the predictive relevance of Q2, and the path coefficient. If the significance value is ≤ 0.05, then the hypothesis is accepted. R2 was obtained at 0.371 or 37.1% which indicated that CG and OS were able to explain the diversity of FV by 37.1%. Then, Q2 is 0.344 which means that CG and OS have a predictive power of 0.344 against FV. The results are shown in Table 4.

Table 4. The Value of R^2 and Predictive Relevance Q^2

Endogen	R^2	Q^2
Firm Value	0.371	0.344

Source: Result of data processing using WarpPLS 7.0

The results of testing the hypothesis on the effect of corporate governance and ownership structure on firm value are shown in Table 5. Testing the hypothesis on the effect of corporate governance on firm value yields a probability value of <0.001 with a path coefficient value of 0.551. This indicates that there is a significant influence of corporate governance on firm value (H1 is accepted). Testing the hypothesis of the effect of ownership structure on firm value obtains a probability value of 0.097, which is greater than the level of significance (α = 5%) with a path coefficient of 0.135. This means that there is no significant effect of ownership structure on firm value (H2 is rejected).

Table 5. Path Coefficient Value

Exogen	Endogen	Path Coefficient	SE	P-Value
Corporate Governance	Firm Value	0.551	0.091	<0.001
Ownership Structure	Firm Value	0.135	0.103	0.097

Source: Result of data processing using WarpPLS 7.0

V. DISCUSSION

The Effect of Corporate Governance on Firm Value

The results obtained from testing the hypothesis indicate that corporate governance has a positive and significant effect on firm value. Corporate governance can influence firm value because corporate governance mechanisms can encourage management to make decisions that benefit shareholders, which in turn will increase firm value. Corporate governance mechanisms can be implemented to reduce agency problems (Siagian et al., 2013). Corporate governance can control the actions of company management and ensure that managers will act in the best interest of shareholders.

Companies with weak corporate governance structures tend to have poor performance as a result of agency conflicts between management and shareholders. Vice versa, companies that are able to implement good corporate governance mechanisms will have good performance. Johl et al. (2016) stated that corporate governance practices can increase firm value because they can mitigate agency conflict, reduce information asymmetry, and can increase managerial efficiency (Nazir & Afza, 2018). The results of this study support the research conducted by Siagian et al. (2013), Nazir & Afza (2018), and Suhadak et al. (2019) which states that corporate governance has a positive and significant effect on firm values.

The Effect of Ownership Structure on Firm Value

The results obtained from the hypothesis testing indicate that ownership structure does not affect firm value. The results contradict the theory that states ownership structure can affect firm value. Agency theory states that ownership structure can mitigate agency problems between managers and shareholders because large shareholders are better able to control the actions of managers, which can lead to the compatibility of goals between managers and shareholders to increase firm value (Fatma & Chouaibi, 2021). The discrepancy between research results and theory can be caused by an increase in firm value that is not directly affected by ownership structure. The results of this study are not in line with the research conducted by Lozano et al. (2016) and Ali et al. (2018) which states that ownership structure affects firm values.

VI. CONCLUSIONS

This study obtained the results that corporate governance positively affects firm value. These results imply that it is necessary to apply good corporate governance mechanisms in a company to ensure that the interests of shareholders are protected. Corporate governance practices are able to control every action and decision made by managers, and ensure that these decisions are made in the best interest of shareholders, in this case being able to increase the welfare and prosperity of shareholders.

VII. RECOMMENDATIONS

Suggestions for further research are to use different industrial sectors as research samples, extend the observation period, use other indicators to measure each variable, and use a broader framework by adding several other variables.

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