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Relationship between Corporate Governance, Leverage and Firm Value: Empirical Evidence from Indonesia

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ABSTRACT: This research investigates the relationship between corporate governance using measurements of company ownership structure in upholding the values of transparency, accountability, equality, and leverage its influence on firm value, and placing growth as a control variable. The research method uses a quantitative approach, analyzing causal relationships through the formulation of hypotheses. The research sample is 175 manufacturing companies in Indonesia which were observed during 2017-2021 with N of 875 observations. The analysis technique uses ordinary least squares with panel regression. The results of the robustness test analysis of the model, growth as a control variable, robustly show that managerial ownership and institutional ownership represent the upholding of corporate governance values with a significantly positive response by investors. Apart from that, the leverage variable positively influences company value. The novelty of the results of this research, firstly, is the enforcement of manufacturing company governance values in Indonesia, represented by managerial ownership and institutional ownership. Second, the company funding structure policy supports the optimal capital structure theory (Modigliani F. and Miller M., 1963)

KEYWORDS: Corporate Governance, Leverage, Firm Value

Gel Clasification: M21, M5.

1. INTRODUCTION

Company value is a reflection of the company performance in the capital market, which reflects the strength of demand from investors and the supply of company shares in the capital market, until an equilibrium stock market price is formed. There are several factors that can influence market performance. In this case, the Company Health Level, the role of the Company ownership structure in influencing the process of determining the Company managerial policies are greatly influenced by the results of the General Meeting of Shareholders which contain the values of transparency, accountability and welfare among members of the company organization which can influence company performance and company value. (Nanda and Damayanti, 2021; Bokpin and Isshaq, 2009; Lee and Foong, 2023).

Empirically, corporate governance influencing company performance, is related to determining company funding policies. Therefore, several previous studies examining the influence of ownership structure on leverage funding policy and dividend policy show a significant relationship (Abdul-Rahim, Nazar and Yaacob, 2021; Mardani, 2022; A.A Zaid *et al.*, 2020; Haron *et al.*, 2021). Further analysis of company performance and capital structure can be a reflection of managerial policies from the operational side and the funding policy side of the firm which cannot be separated from corporate governance, both of which are indicators of the company success, which will be responded to by investors and can influence the firm value. (Harmono *et al.*, 2023; Noguera, 2020); Croci *et al.*, 2023). Based on several previous research, this research investigates the relationship between corporate governance values using measurements of company ownership structure, and the influence of funding policies on company value. The discussion framework for this article chronologically includes: (1) Introduction, (2) Literature review and Hypotheses, (3) Research Method, (4) Results and Discussion, and (5) Conclusion and implications.

Literature Review and Hypotheses

1.1. Firm Value

According to several financial experts, company value is the result of stock trading interactions between the emitens offering shares and investors who represent the strength of market demand until an equilibrium share price is created, which is then used as an indicator of company value. Several previous research results measure company value using share prices, which can be proxied by the Pirce Earnings Ratio (PER), Price to Book Value (PBV), and Tobin's Q values which can reflect the value of the company which represents the interaction between creditors and investors as owners or principal, and company management as agent it is appropriate to agency theory (Michael and MECKLING, 1976). Measuring company value using Tobin's Q which is obtained from (Market Capitalization Value + Book Value of Debt) / Asset Value), can reflect the firm value which involves creditors and investors in responding to company management performance which can form share prices. (Harmono *et al.*, 2023; Supatmi, 2022; Herron and Nahata, 2020; Ben Fatma and Chouaibi, 2023).

1.2. Corporate Governance and Firm Value

Based on a sequence of previous studies, many have studied the relationship between corporate governance and firm value. Conceptually, the value of corporate governance can reflect the company performance in upholding the values of transparency and accountability and the principle of equality between corporate organizations in the process of determining company managerial policies, which is expected to improve firm performance. Therefore, many studies analyze the influence of corporate governance on firm value (Ben Fatma and Chouaibi, 2023; Nguyen and Nguyen, 2020; Noguera, 2020; Harmono *et al.*, 2023).

Measuring corporate governance values often uses company ownership structure and gender diversity. In this case, the company ownership structure includes the share ownership structure of the Independent Board of Commissioners (IBC), Institutional share ownership (IO), Audit Committee (AC), Gender Diversity (GD), Government Board Ownership (GBO, and Managerial Ownership (MO). Various parties to the share ownership structure, and parties who will play a role in the process of monitoring and controlling the process of determining the company strategic policies, can be produced in the General Meeting of Shareholders (GMS) decisions, which can reflect the values of justice, transparency and accountability. The various positions in the share ownership structure will be responded to by investors, in maintaining majority ownership or increasing to majority shareholder, becoming a dynamic process in the management of the company and can influence company performance and company value. (Nanda and Damayanti, 2021; Chen *et al.*, 2022; Ra, 2021). Referring to previous research regarding the relationship between corporate governance and company value, the following research hypothesis can be formulated:

H_a1: Institutional Ownership affects company value

H_a2: Ownership of the Independent Board of Commissioners affects company value

H_a3: The structure of the Audit Committee affects company value

H_a4: Managerial share ownership structure influences company value

1.3. Leverage and Firm Value

Leverage is the company ability to determine the optimal capital structure, according to the company condition in terms of sales demand, and the implementation of company operations in an effective and efficient state, as well as production capacity that needs to be increased, by utilizing debt funding policies. On the other hand, leverage can be said to determine the structure of the weighted average cost of capital which can reflect the optimal capital structure (Modigliani F. and Miller M., 1963). in detail the Proposition Miller (1963) can be shown as follows:

The distribution of Profit after Tax is influenced by Leverage, it is assumed that long-term profit before interest and tax (EBIT) has an average value of X which has a risk class according to the structure of the assets owned by the company, equal to k. The risk class follows the magnitude of X which can be expressed in the form $\bar{X}$Z, in this case $\bar{X}$ is the predicted value of X_1 and randomly Z=X/$\bar{X}$, has the same value for various risk classes k, thus a function is formed $fk(Z)$ Next, an equation is formed:

(1) $X^r = (1-r)(X-R) = (1-r)X + rR = (1-r)\bar{X}Z + rR$ in this case r is the marginal income tax rate (assuming it is an average equation), and R is the interest rate. When ∑($\bar{X}^r$-rR) for (1-r) $\bar{X}$ will be obtained an equation:

(2) $X^r = (\bar{X}^r - rR)Z + rR = \bar{X}^r \left(1 - \frac{rR}{\bar{X}^r}\right)$ Z+rR. Thus, if the tax rate is not equal to 0, it will be distributed to $\overline{X^r}$ and distributed Z, but also the tax rate and leverage level of R/ $\overline{X^r}$. For example if Var (Z) = $\sigma^2 = \sum_{r=1}^{n} \left(\frac{Z-\bar{Z}}{n}\right)^2$ and Var $(X^r) = \sigma^2 (\bar{X}^r)^2 \left(1 - r\,\frac{R}{\bar{X}^r}\right)^2$

Indicating $\bar{X}^r$ After-tax profit variance becomes smaller, higher tax rates will indicate different levels of leverage. Paradoxically, leverage can reduce outcome variability, but in discussing total return variability, it is calculated from interest plus

net profit. The variability of profits for shareholders will of course be greater than leverage even though it is relatively less, comparable to if there were no taxes. Based on equation (1), from the long-term view of the average investor, two components of profit after tax will emerge: (1) uncertainty (1-r) $\bar{X}Z$; and (2) of course development rR. It is recommended that the combined market value of the two be found by capitalizing each component separately. In principle, optimal capital structure theory seeks the optimal weighted average cost of debt capital and own capital costs to support company productivity. The condition of company performance through optimal capital structure is predicted to influence investor preferences and be reflected in company value (Modigliani F. and Miller M., 1958, 1963; Simamora, 2021; (Myers, 1993; De Silva and Banda, 2022). Based on the relationship between the composition of the optimal capital structure and company value, a research hypothesis can be formulated:

H_a5: Optimal capital structure influences company value

Based on the formulation of the research hypothesis, it can be conceptually described in the form of a research model as follows

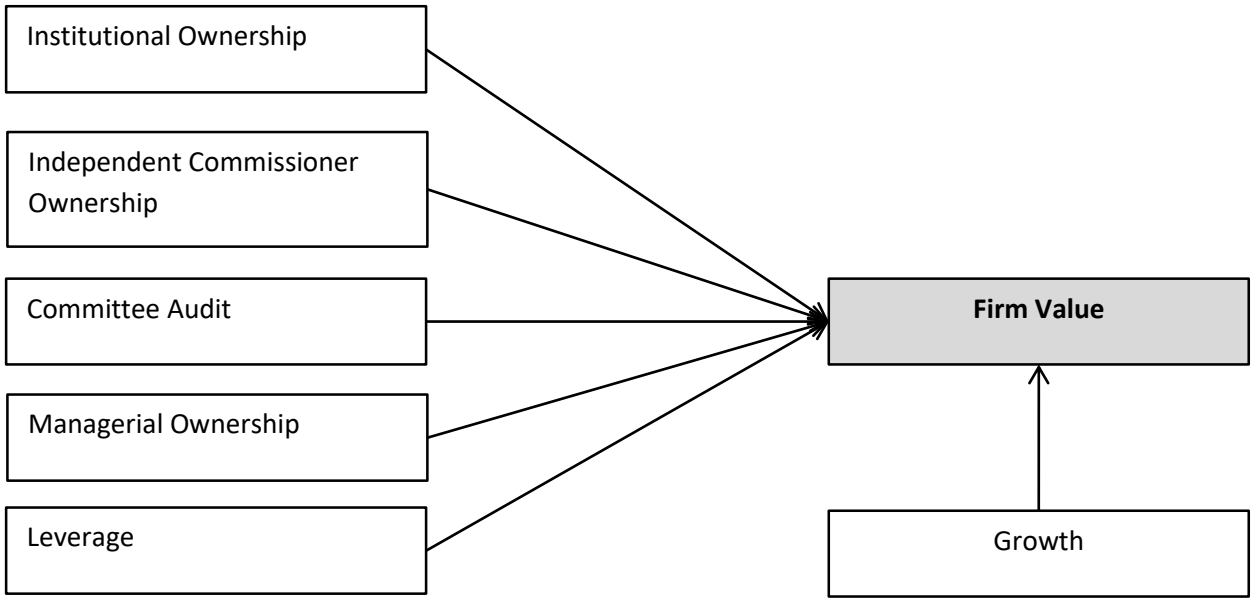

Figure 1: The Research Model is derived from the research conceptual framework

2. RESEARCH METHOD

This research uses a quantitative approach, categorized as an explanatory research, namely examining the causal relationship between independent variables including corporate governance components, including institutional ownership, ownership of the independent board of commissioners, audit committee, managerial ownership and leverage in relation to the dependent variable of company value. The research sample of manufacturing companies that are public on the Indonesian Capital Market, with observations during the 2017-2021 period, obtained a valid N of 864 observations. Using multiple regression analysis techniques, utilizing SPSS software. In detail the analytical technique formula used can be shown as follows:

$$Y_{1.1}\ (FV) = \alpha + \beta_1\ (IO) + \beta_2\ (AC) + \beta_3\ (ICO) + \beta_4\ (S\text{-}CSR) + \beta_5\ (Env\text{-}CSR) + \beta_6\ (Eco\text{-}CSR) + \sum ei$$

(equation 1)

$$Y_{1.2}\ (FV) = \alpha + \beta_1\ (IO) + \beta_2\ (AC) + \beta_3\ (ICO) + \beta_4\ (S\text{-}CSR) + \beta_5\ (Env\text{-}CSR) + \beta_6\ (Eco\text{-}CSR) + \sum \beta_7\ (Growth) + \sum ei$$

(equation 2)

Notes:

$Y_{1;2}$ = Firm value (Tobin's *Q*)

X_1 = Institutional Ownership (IO)

X_2 = Audit Committee (AC)

X_3 = Independent Commissioners Ownership (ICO)

X_4 = Leverage

X_5 = Growth (Lev) as control variable

4. RESULT AND DISCUSSION

4.1. *Descriptive statistics*

Table 1: Descriptive statistics

Description	N	Mean	Minimum	Maximum	Std. Deviation
TobinQ (Y)	864	.677	.310	.910	.087
IO (X1)	864	.510	.310	.720	.086
ACO (X2)	864	.635	.223	.753	.220
ICO (X3)	864	.322	.250	.500	.106
MO (X4)	864	.646	.470	.890	.081
DAR (X5)	864	.361	.206	.476	.053
Growth (X5) control variable	864	4.162	-1.000	179.631	14.224
Valid N (listwise)	864				

The description of the firm value variable using the Tobin Q variable indicator shows relatively stable data variability with an average value of 0.677 and a standard deviation of 0.087. Tobin Q value obtained from $\frac{(Market\ Capitalization+Book\ Value\ of\ Debt)}{Book\ Value\ of\ Assets}$ can describe the extent to which the response of investors and creditors to corporate governance conditions includes the role of the company's ownership structure in participating in the General Meeting of Shareholders (RUPM) process for determining company managerial policies.

On the other hand, the condition of Institutional Ownership (IO) contribution in participating in determining managerial process policies has an average data value of 0.510 with a standard deviation value of 0.086. then the Audit Commeettee (ACO) contributed 0.635 and had a high data variation value of 0.220 standard deviation.

Table 2: Korelasi Antar Variabel (Pearson Correlation)

	TobinQ (Y2)	IO (X1)	ACO (X2)	ICO (X3)	MO (X4)	DAR	Growth
TobinQ (Y2)	1						
IO (X1)	**.098*****	1					
ACO (X2)	.009	.031	1				
ICO (X3)	.012	**-.069****	**-.508*****	1			
MO (X4)	-.002	-.002	.022	-.025	1		
DAR	**.116*****	**.058***	.019	**-.067****	**.445*****	1	
Growth	.038	.047	**-.076****	.040	.007	.025	1

Based on Table 2, it shows that there is a tendency for a relationship between the independent variables Institutional Ownership (IO) and Debt to Assets Ratio (DAR) with the firm value of the Tobin Q with a correlation coefficient of 0.098 significant at an alpha of 1 percent, and 0.116 significant at an alpha of 1 percent. In non-parametric statistics using Pearson correlation statistical analysis, it shows that the role of institutional ownership can dominantly influence investor responses in investment decisions. On the other hand, management behavior tends to utilize leverage funding to meet capital needs to carry out both company operational activities and investment activities. in order to maximize the wealth of capital owners. This condition is in accordance with the optimal capital structure theory (Modigliani F. and Miller M., 1963; Tanjung, 2020; Nugroho and Agustia, 2018; Nanda and Damayanti, 2021)

4.2. RESULT AND DISCUSSION

4.2.1 Robustness Test

The first stage, before discussing the research results, is to first carry out a model sensitivity analysis in order to obtain a model that is robust and shows valid research results. in detail can be seen in Table 3:

Table 3: Results of Research Analysis and Model Sensitivity Test

Variables	Variables Definition	Tobin Q	Tobin's Q, Control Variable (Growth)	Conclusion
Dependent Variable:				
TobinQ (Y)	$\frac{(Market\ Capitalization + Book\ Value\ of\ }{Book\ Value\ of\ Assets}$			
Independents Variables				
IO (X1)	Institutional Ownership	**0.095 (0.005)*** **	**0.098 (0.004)*** **	**Accepted**
ACO (X2)	Audit Committee	0.023 (0.548)	0.028 (0.478)	Rejected
ICO (X3)	Independent Commissioners Ownership	0.040 (0.305)	0.038 (0.334)	Rejected
MO (X4)	Managerial Ownership	**-0.075 (0.045)** **	**-0.078 (0.039)** **	**Accepted**
DAR	Debt to Assets	**0.142 (0.000)*** **	**0.141 (0.000)*** **	**Accepted**
Growth	Growth of Assets as control variable	- -	0.029 (0.395)	
Constant		**0.581 (0.000)*** **	**0.581 (0.000)*** **	
Adj R Square		**0.021 (0.000)*** **	**0.022 (0.000)*** **	**Fit Model**

4.2.2 Discussion

The second stage is discussion of the research results, based on Table 3. Shows a fit model, when the model sensitivity test is carried out when entering the control variable Growth into the model and when there are no control variables it shows a robust model, that is, the consistent results can be used as a basis for discussing the results of the research hypothesis, namely. Firstly, Ha1 Institutional ownership influences company value statistically showing significant results. This means that institutional ownership has a contributing role in upholding corporate governance values, supporting transparent, fair and responsible company managerial processes, which are then responded positively by investors and creditors, showing a linear relationship between the role of institutional share ownership and company value. This phenomenon is in line with the research results (Nanda and Damayanti, 2021; Kurniati, 2019; Siew Yee, Sharoja Sapiei and Abdullah, 2018) The results of the next analysis are to answer H_a2 namely, the audit committee does not statistically affect company value. This condition can illustrate that, according to the duties and functions of the audit committee, they carry out the tasks mandated by the independent board of commissioners, thus the audit committee board concentrates a lot on supervising the managerial process, especially in the form of preparing financial audit reports, and submitting them to the Independent Board of Commissioners. Therefore, the role of the audit committee is not responded to by investors and rejects the research hypothesis, namely the role of the audit committee does not influence company value, consistent with the research results. (Kurniati, 2019)

The discussion of H_a3 on the influence of Independent Commissioners Ownership on company value (Tobin's Q) shows insignificant results, meaning that the presence of Independent Commissioners Ownership is not able to influence the course of the managerial process determined through the General Meeting of Shareholders (GMS) in the managerial process of determining the company strategic policies. It seems that institutional share ownership is more dominated, this is a contradiction with previous research results (Kurniati, 2019; Nugroho and Agustia, 2018; Nanda and Damayanti, 2021).Hypothesis H_a4 tests the influence of managerial ownership on company value. Empirically, managerial ownership has a negative influence on company value. This means that corporate governance carried out by management has negative implications for investors perceptions. It is possible that management will take action to determine policies that are profitable for themselves and less profitable for investors, for example a policy of retaining earnings, increasing bonus programs for employees which can reduce profits, and other managerial policies that, in principle, are beneficial for company management. This is in line with the research results (Siew Yee, Sharoja Sapiei and Abdullah, 2018; Noguera, 2020; Wu, 2012; Worokinasih and Zaini, 2020).

Finally, the results of the Ha4 analysis of leverage's influence on company value show a regression coefficient of 0.142 (p=0.000), meaning that the contribution of the leverage funding strategy policy is empirically able to show a positive role in supporting the company operational activities and funding to improve performance, which in the end is responded to positively by investors.

5. CONCLUSION

Based on the results of the research analysis, the main conclusions related to research on the influence of leverage on company value can be drawn as follows:The corporate governance component consists of institutional ownership, ownership of an independent board of commissioners, audit committee, and managerial ownership which can influence company value, namely: institutional ownership and managerial ownership, in the context of upholding governance values. This means that the role of the presence of the company's institutional ownership board and management's behavior and actions can indicate the existence of a governance value enforcement mechanism process and can influence the condition of the company's value performance. Implications for practice, for investors, the condition of corporate governance and optimal leverage capital structure is important information that must be considered in investment decisions. And the theoretical implications can strengthen agency theory and optimal capital structure.

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