

Corporate Governance and Firm Performance: The Moderating Effect of State Ownership

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This study aims to examine the impact of corporate governance on firm performance and whether state ownership alters the relationship of corporate governance with firm performance. Using an Indonesia data set and a composite measure comprising six individual components of corporate governance quality, we reach the following evidence. First, corporate governance quality is positively associated with firm performance, indicating that ameliorating corporate governance can bring benefits to stakeholders. Second, state ownership is positively related to firm performance, demonstrating that governmental support in developing countries is beneficial to firm growth. Finally, state ownership negatively moderates the effect of corporate governance quality on firm performance, showing that improving corporate governance on state-owned firms is less effective in terms of performance improvement. Such a result may imply that business operations in state-owned companies are more bureaucratic or human-driven.

JEL Codes: G32, L25, M41

Keywords: corporate governance, state ownership, performance

1. Introduction

Agency theory argues that managements do not always act for the shareholder's interest. The shareholder who realized the conflict an interest feel the need to incurred cost to monitor and convinced the manager do not take an action which can lead to harm their wealth. The management decision usually refers to Chief Executive Officer (CEO) since CEO is the position who decides the corporate strategy. Dent (1981) explained about how the old model of corporate governance is board of directors that manage corporation and change to new one which the corporation is managed by executive officers and the board monitors management's performance. Since CEOs is the one who always under the spotlight, Steinberg and Fix (2000) saw the board lack of contribution to corporation.

In general term, there are two types of ownership in Indonesia, state ownership enterprises (SOE) which called "Badan Usaha Milik Negara/BUMN" and non-state ownership (non-SOEs) or non-BUMN. SOEs in Indonesia definition based on Law No. 19 of 2003 is business entities that all or most of the capital is owned by the state through its investment directly derived from the separated wealth of the country. SOEs in Indonesia have characteristics such as the

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government must have at least 51% ownership in SOEs. Besides government ownership, SOEs usually engaged in energy, gas, and water or other important production because the constitution required those resources shall be under the powers of the State and shall be used to the greatest benefit of the people.

The purpose of make SOEs go public is to pursue the management act more professional and create profitability. Unfortunately, in Indonesia, investors saw this act as a government way to decrease the deficit which makes them not really interested in SOEs management (Hasnawati, 2009). Mixed results find in studies of state ownership and firm performance. State ownership has a positive impact was found by Utama and Handy (2011), Kuznetsov and Muravyev (2001), and Rasli, Goh, and Khan (2013). Meanwhile, Cornett, Guo, Khaksari, and Tehranian (2009) find the negative impact because the non-SOEs performed better compare to SOEs. The same result in Vietnam companies find by Tran, Nonneman, and Jorissen (2014).

This research aimed to know how CG impact to firm value in Indonesia and whether the SOEs performed better or worse than non-SOEs. We find CG has positive relationship to firm value. We also find SOEs performed better than non-SOEs but the more ownership in SOEs, negatively moderates the effect of CG to firm value.

2. Literature review and hypothesis development

2.1 Agent theory and corporate governance

Agency theory introduced by Jensen and Meckling (1976) which they defined as: “a contract under which one or more persons (the principal(s)) engage another person (the agent) to perform some service on their behalf which involves delegating some decision making authority to the agent.” This kind of relationship creates problem when the agent is believe not always act for principal interest and it makes principal incurred costs to monitor the agent. Eisenberg (1975) proposal for new model of corporate governance could be one of the solutions to eliminate costs by principal. He offered monitoring corporate officers (agent) as a board’s function. The board function identified by PricewaterhouseCoopers LLP after conducted a global survey are; strategy and planning, risk management, tone at the top, measuring and monitoring performance, transformational transactions, management evaluation, external communication and board dynamics (Steinberg and Fix, 2000) . Eisenberg, Steinberg, and Fix realized perception how CEO (management) seemed to dominate and the board looks like lack of contribution. They believe board contribution is the area that needs more improvement to make the corporate governance become effective and efficient.

The survey conducted by PricewaterhouseCoopers LLP as mentioned above is one of the ways to measure CG although this way took two year period. Liu, Uchida, and Yang (2010) used managerial ownership, information disclosure quality, board structure and state ownership for the CG measurement. Some of stock exchanges from several countries made

corporate governance indices to promote better governance practices in companies (Grimminger and Benedetta, 2013). The example of CG indices is index by Johannesburg Stock Exchange (JSE) from South Africa which covered 4 broad categories, environment, society, governance, and related sustainability concerns.

2.2 Corporate Governance and Performance

Santos and Brito (2012) refer firm performance as a subset of organizational effectiveness that covers operational and financial outcomes. Prior studies about measure firm performance are Utama and Handy (2011) that used Price to Book Value (PBV) ratio as a measurement for firm performance meanwhile Du, Tian, and Zhang (2013) measured with Economic Value Added (EVA). Besides EVA, Pinto and Santos (2011) believed Market Value Added (MVA) provide a more accurate evaluation of the firm's performance. Tobin's Q ratio, the method to estimate the fair value of the stock market, choose by Liu, Uchida, and Yang (2010) and Rashid and Islam (2013). Khatab (2011) used Return on Assets (ROA) and Return on Equity (ROE) for the case study of Karachi stock market.

However, whether a company can continue to increase earnings is always of a major concern to its shareholders. Friedman (1970, as cited in Pfarrer 2010) stated the main purpose of the firm is to maximize shareholder wealth. CG could be a solution according to Utama and Utama (2005, as cited in Utama and Handy, 2011). They described CG as a system and structure which can manage a firm in order to enhance the value of the shareholders. The definition by Lander and Reinstein (2005) also support those definition,

“Corporate governance can be defined as the laws, policies, and procedures that ensure that (1) firms run in the interest of owners and (2) scarce resources are allocated, managed, and redeployed to maximize productivity and value.”

Studies showed relationship between CG and firm performance. An empirical study at Jordanian companies by Al-Haddad, Alzurqan, and Al_Sufy (2011) find that ROA and Earning per Share (EPS) has direct positive relationship with corporate governance. In Indonesia companies, CG practice has positive impact towards the firm value at stock market (Utama and Handy, 2011). Liu, Uchida, and Yang (2010) research result showed how CG succeeds to reduce the expropriations of minority shareholders that become sever during a crisis period. Rashid and Islam (2013) find board members, one of the components of CG, have positive impact due to healthy conflicts among the board members.

Nur'ainy et.al (2013) used TARIF principle which consists of transparency principle, accountability principle, responsibility principle, independence principle, and fairness to measure CG in Indonesia. They find CG has direct effect on corporate performance. As mentioned above, relatively to prior studies using individual indicators as corporate governance proxies, this study employs a more complete indicator, and set up the following

hypothesis to re-examine the relationship between corporate governance and firm performance.

H1: Corporate governance is positively related to firm performance.

2.3 State ownership and performance

Definition of SOEs in Indonesia according Law No. 19 of 2003 is business entities that all or most of the capital is owned by the state through its investment directly derived from the separated wealth of the country. Separated means SOEs financial statement not included in state budget.

The main characteristic of SOEs in Indonesia is their capital owned fully or at least 51% by Indonesia government. Another characteristic is most of the SOEs engaged in the sector of the production which are important for the country such as energy, gas, and water because the constitution required those resources shall be under the powers of the State and shall be used to the greatest benefit of the people. Therefore since the beginning SOEs has more advantage towards non-SOEs.

Asia financial crisis in 1997-1998 impacted Indonesia in the worst way which led the Indonesia government to accept financial assistance from The International Monetary Fund (IMF). However there was a requirement on structural reforms to restore the health of the economy and confidence of the investor (Fischer, 1998). Regulations have been made and institutions have been established to monitor the implementation of good corporate governance (Warganegara, Hutagaol, Saputra, & Anggraini, 2013). Research conducted by Warganegara et al. (2013) finds SOEs in Indonesia perform better governance than non-SOEs.

Du, Tian, and Zhang (2013) viewed SOEs as a companies that have advantages unparalleled technical, personnel, and financial. These advantages make SOEs occupies an important position in China. In Indonesia, according to regulation, the background of privatization of the SOEs is to push companies act more professional. However, Hasnawati (2009) concludes that investors saw privatization to decrease the state deficit since she find there are a lot of individual investors who did short range sell with the SOEs share and in general investors are not interested in SOEs management.

Hasnawati (2009) studied involves 13 SOEs listed in Indonesia and find ownership do not affect the performance of the SOEs. In a contrary, Utama and Handy (2011) found SOEs in Indonesia have produces better good corporate governance compared with non-SOEs and also CG has positive influence toward firm value.

In Russia, during pre-crisis, some evidences showed majority state ownership had positive impact because they played important role in corporate governance to limit the scope of

shareholder expropriation (Kuznetsov and Muravyev, 2001). Their evidence support Black et al. (1999) which presented the suffered of profitable oil extraction enterprise from loss after the privatization.

Rasli, Goh, and Khan (2013) find that state ownership exhibits a positive and statistically significant relationship with firm performance. The results support their argument which is government intervention has caused firm to secure protection from market competition.

Before global financial crisis, Beuselinck, Cao, Deloof, and Xia (2013) find government ownership was negatively related with firm value but after the global crisis the relationship changed to positive. The positive effect was driven by firms located in countries with lower risk i.e. corruption. More investment by firms with government ownership during the crisis also indicated that the ownership reduced restriction to finance for firms during the crisis.

An international comparison between privately owned versus state owned banks by Cornett, Guo, Khaksari, and Tehranian (2009) uncovers how privately owned banks more profitably, held more core capital, and had less credit risk than state owned banks. In countries which have more government involvement and political corruption in the banking system, those differences are more significant. The same effect also find by Tran, Nonneman, and Jorissen (2014) in Vietnam companies. The state ownership has a negative effect on firm profitability, ROA and ROE. To examine how state ownership affects firm performance in Indonesian firms, this study sets up the following hypothesis.

H2: State ownership is related to firm performance.

The two hypotheses above are talking about how corporate governance (CG) and state ownership related with firm performance. We are curious to see whether the state ownership actually affect the relationship between CG and firm performance. Similar like case study in Russia by Kuznetsov and Muravyev which they stated state ownership played important role of CG implementation and it affects company profit.

H3: State ownership has moderating effect on the relationship between corporate governance and firm performance.

3. Methodology

3.1 Data and sample

The observation used from public companies listed in Kompas 100 during 2011 and 2012 except for financial institutions since bank as highly regulated industries will have higher debt equity ratios for equivalent levels of risk than the average nonregulated firms (Jensen and Meckling, 1976). There are eight sectors industries and twenty two sub sector industries which classified by Indonesia Stock Exchange called as Jakarta Stock Industrial Classification

(JASICA). The segmentation is generally based on Indonesia Business Classification and follows the International Standard Industrial Classification (ISIC) with some adjustments since business cores in Indonesia has wide variety type.

Following our criteria which are included in Kompas 100, not included as financial institutions, listed in Indonesia Stock Exchange, and has completed observation to calculate variable, the total final sample are 138 observations. There are 24 SOEs observations from several sectors; Property, Real Estate and Building Construction, Mining, Infrastructure, Utilities, and Transportation, Consumer Goods Industry, and Basic Industry and Chemicals.

Table 1 Sample attrition

Observations Included in The List of Kompas 100 during 2011- 2012		200
Less Financial institutions	(24)	
Less Not Listed in Indonesia Stock Exchange	(16)	
Less Missing observations	(22)	
Final sample		138

3.2 Empirical models

To test for hypotheses 1 to 3, this study builds the following model
 $PERFORMANCE = \beta_0 + \beta_1 CGI + \beta_2 STATEOWN + \beta_3 CGI * STATEOWN + \beta_4 CEO + \beta_5 LEV + \beta_6 SIZE + (YEAR) + (IND) + \varepsilon$

Where

- Performance = Return On Assets,
- CGI = Total Corporate Governance Index,
- STATEOWN = State Ownership,
- CEO = Chief Executive Officer dummies (if CEO and chairperson are different person the dummy is 1, if the same person is 0),
- LEV = Debt to Equity,
- SIZE = Log of Total Assets,
- YEAR = year dummies (2011 is 1 and 2012 is 0),
- IND = industry dummies.

4. The Findings

4.1 Descriptive statistics

The measurement of CG Index (CGI) by JSE has total 6 indicators and 31 sub indicators. We expected as a total value of CGI, there will be some of the results which not significant to firm performance but as an individual indicator it could be lead to the different results becomes significant. Therefore, we used 6 subs CGI as independent variable besides the whole CGI. Table 2 showed the mean value for total CGI are 84,2%, it means that the compliance of CGI

almost fulfilled by the companies. As an individual indicator, CGI 3 or indirect impacts indicator has the highest value of compliance with 93,7% meanwhile the lowest value with total compliance 63,1% is the compliance of CGI 2 or code of ethics/conduct indicator. The mean of total ownership by the state only 10,8% since there are only 24 observations of SOEs from 138 observations. Size of company which calculated with logarithm of total assets has means value 28.272. These results indicate that mean value of total assets for the observation companies is around IDR 1,898 trillion. The mean value of leverage is 0.946 or it means 94,6% financing by the debt not equity. The return of total assets has mean value 0.135 or income generated from the total assets produce return 13,5%.

Table 2 Descriptive Statistics

	N	Mean	S.D.	Q1	Q2	Q3
CGI	138	0.842	0.101	0.806	0.871	0.903
CGI1	138	0.891	0.086	0.861	0.889	1.00
CGI2	138	0.631	0.143	0.571	0.714	0.714
CGI3	138	0.937	0.223	1.00	1.00	1.00
CGI4	138	0.780	0.097	0.70	0.80	0.90
CGI5	138	0.701	0.207	0.667	0.667	0.667
CGI6	138	0.700	0.245	0.50	0.50	1.00
STATEOWN	138	0.108	0.239	0.00	0.00	0.00
SIZE	138	28.272	3.518	28.263	29.443	30.178
LEV	138	0.946	2.682	0.458	0.915	1.493
ROA	138	0.135	0.111	0.070	0.110	0.170

CGI: Total Corporate Governance Index; CGI1: Sub-CGI Index-Board Practice; CGI2: Sub-CGI Index-Code of Ethics/Conduct; CGI3: Sub-CGI Index-Indirect Impacts; CGI4: Sub-CGI Index-Business Value and Risk Management; CGI5: Sub-CGI Index- Broader Economic Issues; CGI6: Sub-CGI-General; STATEOWN: State Ownership; SIZE: Log of Total Assets; LEV: Debt to Equity; ROA: Return on Assets

4.2 Multiple regression analysis

Table 3 showed regression analysis of the whole model GC Index and state ownership which is significant with F value is 2.838 and $p < 0.001$. The explanatory model, adjusted R^2 , is 0.158. The study shows, CGI is significant and positive associated with firm performance (coef= 0.423, $t=4.078$). When the companies have better value of CGI their firm performance will increase and it means the first hypothesis is accepted. This result supported prior research by Utama and Handy (2011) where CG has positive impact to firm value.. The second hypothesis also proved by the results of state dummy variables showed value 1.851 with significance at the 10% level. Since we used 1 for the state ownership more than 50% and 0 for state ownership below 50%, it means that SOEs perform better than non-SOEs. Prior studies by Warganegara et al. (2013) also showed SOEs in Indonesia implement strong governance compared with non-SOEs. The last hypothesis about state ownership has moderating effect for relationship between CGI and ROA also accepted in this research.. The interesting results are for the moderating effect of state ownership with the total value -1.974 and significance at the 10% level. The negative sign means that higher state ownership, their

CGI only affected less their firm performance. Otherwise, the lower state ownership, firm performances is stronger affected by CGI. The CEO duality also has negative significant relationship to ROA. The reason is it could be caused by only few companies in this research that choose different person for position of CEO and chairperson.

As we mentioned before that we also focus on relationship between sub indicator of CGI and firm performances, table 4 showed the regression for each sub indicator. The interaction variable between Sub CGI 1 until 4 and state ownership showed a negative significant relationship towards ROA. The same results with total CGI are as shown in table 3.

Table 3 The relation between corporate governance and state ownership

	Coef.	T
(Constant)	-0.098	-0.926
CGI	0.423	4.078***
STATEDUM	0.322	1.851*
CGIXSTATEOWN	-0.591	-1.974*
CEO	-0.098	-2.672***
LEV	-0.007	-2.132**
SIZE	-0.002	-0.702
Year dummy		(INCLUDED)
Industry dummies		(INCLUDED)
Number of Observations		138
F-value		2.838***
R ²		0.244
Adjusted R ²		0.158

1. The definitions of variables see Table 2.

2.*Statistical significance at the 0.10 level;** Statistical significance at the 0.05 level; *** Statistical significance at the 0.01 level

Table 4 the relation between Sub-CGI Indices and State Ownership

	CGI1		CGI2		CGI3		CGI4		CGI5		CGI6	
	Coef.	t	Coef.	t	Coef.	t	Coef.	t	Coef.	t	Coef.	t
(Constant)	0.015	0.090	0.074	0.851	0.073	0.859	-0.057	-0.511	0.122	1.425	0.120	1.331
CGI [1 to 6]	0.173	1.142	0.247	3.376***	0.192	4.369***	0.358	3.135***	0.164	3.286***	0.054	1.109
STATEDUM	0.283	1.757*	0.276	2.133**	0.368	2.266**	0.328	1.745*	0.196	1.741*	0.034	0.265
CGI1XSTATEOWN	-0.465	-1.720*										
CGI2XSTATEOWN			-0.619	-2.153**								
CGI3XSTATEOWN					-0.564	-2.178**						
CGI4XSTATEOWN							-0.639	-1.900*				
CGI5XSTATEOWN									-0.408	-1.651		
CGI6XSTATEOWN											-0.050	-0.218
CEO	-0.075	-1.958*	-0.086	-2.331**	-0.050	-1.394	-0.080	-2.176**	-0.105	-2.715***	-0.072	-1.854*
LEV	-0.005	-1.267	-0.005	-1.442	-0.009	-2.603**	-0.006	-1.708*	-0.007	-1.986**	-0.004	-1.194
SIZE	0.000	0.155	-0.001	-0.476	-0.002	-0.767	-0.001	-0.417	-0.001	-0.463	0.001	0.369
Year dummy	0.013	0.556	0.002	0.099	-0.001	-0.054	0.001	0.064	0.000	0.024	-0.002	-0.110
Industry dummies		INCLUDED		INCLUDED		INCLUDED		INCLUDED		INCLUDED		INCLUDED
N		138		138		138		138		138		138
F-value		1.573*		2.375***		3.098***		2.313***		2.153**		1.330
R ²		0.152		0.213		0.261		0.208		0.197		0.131
Adjusted R ²		0.055		0.123		0.177		0.118		0.105		0.033

1. The definitions of variables see Table 2.

2.*Statistical significance at the 0.10 level; ** Statistical significance at the 0.05 level; *** Statistical significance at the 0.01 level

5. Summary and Conclusions

Corporate governance as a system is supposed to be leading the better performance of the company because it contains with procedures to ensure firm enhance their value. We find that corporate governance has positive significant relationship to ROA. When it comes to compared performance based on ownership, SOEs performed better than non-SOEs. The results supported previous studies about the advantages of SOEs such as perform in important sector for public and have fewer restrictions when it comes to seek financing. Although the SOEs have a better performance, but when the ownership of the state becomes bigger, it will weakening CG affect to the firm value. In practical, it means the management becomes more rigid and conservative to create firm value.

This study contributes to raise a concern especially for Indonesia government because although SOEs could outperform non-SOEs but there are some evidences that proved state ownership decrease the firm value. The government should change the public perception that the purpose of privatization only to cover the deficit and there is no intention of SOEs to become more professional and create value for the shareholders.

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