THE EFFECT OF CORPORATE GOVERNANCE ON FIRM PERFORMANCE IN INDONESIA SHARIAH COMPLIANT COMPANIES

BY

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ABSTRACT

The practice of Corporate Governance (CG) is believed as one of the most important part in a corporate which acts as a tool on strategical decision that will lead companies into the better or worse performance. The discussion over the effect of corporate governance on firm performance and based on those researches there is no any consensus in term of how CG should behave. On the other hand, from Islamic point of view, value creation is more encouraged rather than value destruction, additionally, in Islam wealth distribution also encouraged compares to merely profit maximisation. This study aims to investigate the effect of CG variables to firm performance in Shariah Compliant companies in Indonesia. The CG variable used are: board size (BS), board independent (BI), Concentrated Ownership (CO), Ownership Identity (OI), and Largest Shareholder (LS). On top of that, Indonesia is classified as a developing country which ownership highly concentrated and most companies own by family clan. Whereas value of company measured by two methods namely accounting method with return on asset (ROA) and return on equity (ROE), and market-based method with Tobin's Q (Q) ratio as the proxy. This research also covering further the extension of the quantitative findings with respect to Islamic theory. This study utilises 287 companies as sample from Indonesia Shariah compliant companie over the span 2010-2015 which generated 1772 observations. By employing Generalized Method of Moment (GMM) regression with three different models, the finding shows BS and CO has a positive significant effect on Q whereas, LS has a negative significant effect on Q. At the second Model, BI has a positive significant effect on ROA and LS has a negative significant effect on ROA. Another model in this study depicts that BS has a negative significant effect on ROE while BI has a positive significant effect on ROE. In accordance of the three-model comparison it can be said that the independent director is able to create a value in company due to its expertise and concentrating the ownership to small number of people with ownership more than 5% also will generate value for company due to efficiency in the voting and strategical decision rather than over dispersing or relying only to single rider shareholder.

خلاصة البحث

هناك اعتقاد سائد بأن ممارسة حوكمة الشركات (CG) هي واحدة من أهم عناصر التي تتفاعل كأداة على القرارات الاستراتيجية واللتي تقود إلى أداء أفضل أو أسوأ للشركات. إن النقاش حول تأثير حوكمة الشركات على قيمة الشركة وعلى أساس تلك الأبحاث ليس هناك أي إجماع على كيفية التصرف والعمل. من ناحية أخرى من وجهة النظر الإسلامية، يتم التشجيع على انتاج واحداث القيمة أكثر من تخريبها، بالإضافة إلى ذلك، الإسلام ينصح بتوزيع الثروات بدل التركيز على زيادة الارباح. تهدف هذه الدراسة إلى التحقق من تأثير متغيرات (CG) على القيمة المؤسسة في الشركات المتوافقة مع الشريعة في إندونيسيا. تم استخدام متغير (CG): حجم المجلس (BS)، استقلالية المجلس (BI)، الملكية المتركزة/المتجمعة (CO) ، هوية الملكية (OI)، والمساهم الرئيسي (LS). علاوة على ذلك، تصنف إندونيسيا كدولة نامية والملكية فيها غالبا المتركزة/المتجمعة، تُمتلك معظم الشركات من قِبَل العائلات أو العشيرة. في حين تقاس قيمة الشركات بطريقتين: طريقة المحاسبة مع العوائد على الأصول (ROA) والعوائد على حقوق المساهمين (ROE)، والطريقة القائمة على أساس السوق مع مؤشر توبينز (Tobin's Q) كبديل. هذا البحث أيضًا يغطي نطاق النتائج الكمية فيما يتعلق بالنظرية الإسلامية. تستخدم هذه الدراسة 287 شركة كعينة من مؤشر القوائم الأسهم الشرعية الإندونيسية (ISSI) خلال الفترة 2010-2015 والتي أنتجت 1772 ملاحظة. من خلال استخدام مؤشر الانحدار المعمم اللحظة (GMM) مع ثلاثة نماذج مختلفة، تظهر النتائج أن حجم المجلس (BS) والملكية المتركزة/المتجمعة (CO) لهما تأثير إيجابي كبير على Q بينما المساهم الرئيسي (LS) تؤثر سلبا بشكل كبير على Q. في النموذج الثاني، استقلالية المجلس (BI) لديها تأثير إيجابي مهم على العوائد على الأصول (ROA)والمساهم الرئيسي (LS) له تأثير سلبي كبير على ROA. في هذه الدراسة نموذج آخر يوضح أن حجم المجلس (BS) له تأثير سلبي كبير على العوائد على حقوق المساهمين (ROE). في حين أن استقلالية المجلس (BI) له تأثير إيجابي كبير على ROE. وفقا للمقارنة بين النماذج الثلاثة، يمكن القول إن المدير المستقل قادرعلى رفع قيمة الشركة بسبب خبرته واجتماع الملكية لدى عدد قليل من الأفراد الذين يملكون أكثر من 5٪، أيضا يضيف قيمة للشركة بسبب الكفاءة في التصويت والقرار الإستراتيجي بدلاً من الإفراط أو الاعتماد فقط على المساهم الوحيد.

APPROVAL PAGE

I certify that I have supervised and read this study and that in my opinion, it conforms to acceptable standards of scholarly presentation and is fully adequate, in scope and quality, as a thesis for the degree of Master of Science (Islamic Banking and Finance).

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Razali Haron
Supervisor

I certify that I have read this study and that in my opinion it conforms to acceptable standards of scholarly presentation and is fully adequate, in scope and quality, as a dissertation for the degree of Master of Science (Islamic Banking and Finance).

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DECLARATION

I hereby declare that this dissertation is the result of my own investigations, except where otherwise stated. I also declare that it has not been previously or concurrently submitted as a whole for any other degrees at IIUM or other institutions.

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CHAPTER ONE
INTRODUCTION

1.1 BACKGROUND OF THE STUDY

Corporate Governance is one of the most utilised tools in a business institution to ensure the best management practice in conducting the business operation. The term “corporate governance” is used frequently during the economic and political shift in the Organisation for Economic Co-operation and Development countries in the mid ‘80s (Marie L’Huillier, 2014). The frequent discussions held on corporate governance topics are mainly to urge the authorities to construct the landscape of corporate governance practices. Many literatures point out that the current concept of corporate governance is inclined towards the agency theory, originated from the two main interest divergences namely shareholder interest and management interest (Haron, 2018; Marie L’Huillier, 2014). The shareholder’s interest mainly focuses on ways to amplify the company’s value and profit whereas management interest lies in maximising management’s benefits at the company. It is believed that these problems occur due to the separation of ownership and control in corporate businesses. Thus, ownership structure plays a vital role to deter the occurrence of so-called agency problem (Haron, 2018; Jensen and Meckling, 1976; Siagian, Siregar, and Rahadian, 2013).

In order to avoid the issues of the agency conflict, shareholders will usually share a fraction of the ownership to several parties that are involved in the business. This is generally done in two ways; 1) by concentrating the ownership and 2) by using ownership identity. Oftentimes, the main purpose of concentrated ownership is to strengthen the power of the shareholders against managers of dispersed ownership. Concentrated ownership companies are also found to be able to give a high valuation ratio and profit margin due to its ability to focus on certain target quickly (Mishra and Kapil, 2017; Yasser and Mamun, 2015). However, in some cases, concentrated ownership companies host a low governance quality especially companies that are highly connected to politics, as it becomes vulnerable when there is a shift in the political power of a country (Dicko, 2017).

Ownership identity refers to the largest ownership shareholder to whom the company belongs. In China for instance, ownership identity has been categorised into either a state-ownership or non-state ownership (Han and Erming, 2012). In the case of Indonesia, some researchers concur that the largest ownership belongs to family ownership and foreign ownership (Darmadi, 2016)

Another essential element to reduce the agency conflict is by establishing a board of directors and to structure it efficiently. The board mainly acts as the highest authority in the corporate and promotes the protection of shareholders' interest by safeguarding the capital or optimising the wealth. The board is also responsible to monitor the management's practice against any fraud that could jeopardise the shareholder's interest (Oba, Tigrel, and Sener, 2014; Swartz and Firer, 2005).

There are many considerations and factors in setting up the best model of board structure depending on the company's necessities. Some of them are: country's regulation of company jurisdiction, size of the company, and the core business of the company. Consequently, in most of the cases, the structure will also be reflected in the size of board and the amount of board independent appointed by the majority shareholders. According to Darmadi and Sodikin (2013), the independent board members have the ability to add more knowledge to the management due to high experience, expertise and network. Therefore, given that the board structure is essential in the company, most of the time it is compulsory for the listed firms to include the board structure as part of their corporate governance mechanism.

In Indonesia, the issues regarding ownership and corporate governance have been addressed by a number of developments in government policies. The improvement was motivated predominantly by the 1997-1998 financial turmoil that hit the Asian market. The crisis left a massive impact and weakened Indonesia's economy which subsequently effected many corporations. The weak corporate governance system in place during that time also contributed to issues such as corruptions and political clashes. In 1999, Indonesia established the National Committee to issue a decree on corporate governance in collaboration with the Ministry of Economic, Finance, and Industry as the coordinator in order to strengthen the country's corporate governance system. The establishment resulted in positive developments in business laws such as Capital Market, Monopolistic Practice, and Business Supervision Act (Refer to: Dercon, 2007; International Finance Corporation, 2014).

To facilitate the capitalisation of the business environment, Indonesia founded the Indonesia Stock Exchange (IDX) which was subsequently privatised as an integral part of the financial system. Since its establishment in 1992, the price index increased from IDR 300 to IDR 5,214.976 in 2013 (Association of Indonesia Securities Companies, 2013). With such significant progress, Indonesia Capital Market authority has implemented several guidelines to ensure the safety of investments against the failure of companies' practices especially for public listed companies. Some of the prominent guidelines issued by the IDX are corporate taxonomy, corporate governance guideline, and trading guideline (IDX, 2018).

Indonesia is renowned for its Muslim's population of 87.2% out of 260 million inhabitants (CIA, 2016). Triggered by the enormous Muslim population, the country has been striving to cater to the Muslim's financial market by setting up many Islamic based institutions. One of the efforts initiated by the country is by developing Islamic Capital Market Indices. Jakarta Islamic Index (JII) consists of 30 of the biggest market players while ISSI (Indonesia Shariah Stock Index) comprises a large number of companies. Both indices have been continuously utilised as the Islamic investment instruments and benchmark in the industry (IDX, 2018).

The establishment of the Islamic Index indubitably begun with the existence of the Islamic screening method. The method is mainly based on the fatwa of Majlis Ulama Indonesia (MUI) on capital market activities such as transaction, Shariah screening and Shariah mutual fund. On the other hand, the Financial Services Authority (OJK) regularly reviews, develops and supervises the market (Haron and Adeyemi, 2016; OJK, 2015). In addition, by the end of 2014 the index has successfully accounted 56.37 % of the total firms listed on the Indonesia Stock Exchange (OJK, 2015).

1.2 PROBLEM STATEMENT

In managing the agency conflict between the shareholders and the management, the agency cost in the business especially in big corporations can no longer be circumvented. Therefore, some strategies have been implemented to ensure the agent's decisions are still in line with the interest of the shareholders. One of the strategies is by implementing a corporate governance model that consists of a board of directors and an independent board to supervise the business operation. By structuring the best model of ownership, shareholders and investors will be able to reinforce the control in achieving profit maximisation (Leech and Leahy, 1991; Susanti and Nidar, 2016). A concept called *concentrated ownership* will play a crucial role in the structure as one of the shareholders' privileges is to vote when disputable matters related to the business arise. Those with higher shares could possibly override many important decisions via the voting system (Hanafi, Setiyono, and Sanjaya, 2018; R. La Porta, Lopez-de-Slianze, and Shleifer, 1999).

In contrast, the stewardship theory and the stakeholder theory emphasise more on the economic interest among the partners as discussed in agency theory. The prominent distinction between the agency and stewardship theory lies in the function of the managers. The stewardship theory managers are not merely motivated by their personal goals, rather they focus on all the actions that are aligned with the principal objectives (Davis, Schoorman, and Donaldson, 1991; Marie L'Huillier, 2014). On the other hand, stakeholder theory is built mainly for the benefits of the governance and business parties in order to address the issues that are of the interest of the company. Business parties are those who are involved in the company's market, hierarchies, clan, community and association (Swartz and Firer, 2005). Hence, stakeholder theory suggests that a company must operate in a well-balanced manner by listening to issues that are taking place and addressing it to the stakeholders (Marie L'Huillier, 2014).

Generally, when it comes to empirical study there are a variety of findings from the past literature pertaining to the ownership and family ownership and its effects on the firm performance. Similarly, past literature have also found different findings on the effect of corporate governance variables, especially regarding the board structure. A study conducted on the USA's public-listed companies shows that the presence of the board of directors and the independent board has a significant impact on the shareholders' gain during the tender offer period. Researchers believe that this behaviour can increase shareholders' wealth (Cotter, Shivdasani, and Zenner, 1997). In addition, Mishra and Kapil (2017) explored Tobin's Q and ROA (Return on Asset) using the similar model as a dependent variable in India and found that the size of the board of directors and the independent board are insignificant to the firm performance. However, the study concludes that if the institutional ownership is added to the equation, the behaviour of the board size will change positively with a significant effect in respect to the ROA.

Conversely, a study in Nigeria shows that the number of people who sits on the board of directors including independent director has a non-significant effect on the firm's performance. Subsequently, the study assumed that the occurrence of such behaviour is due to the decrease in supervision efficiency as the number of board members increases (Ujunwa, 2012). A study in India discovered a fascinating outcome when comparing both family and non-family companies from the year 2010 to 2012. It is found that the relationship between the board structure and firm performance of the family-categorised companies tend to be negative as compared to non-family companies (Bhatt and Bhattacharya, 2017).

There is no evidence to support the findings relating to the ownership structure from previous research conducted based on empirical studies. However, Tam et al. (2007) ascertained that the practice of concentrated ownership would have a significant positive impact on the firm performance. They also argued that the goal of concentrated ownership is to uphold the shareholders' interest. They added that regardless of the type of ownership identity (individual, state, foreign, and mixture), the verdict to concentrate the ownership will benefit the shareholders. Several studies with similar findings include Leech and Leahy (1991), Rajablu (2016) and Yasser and Mamun (2015).

Meanwhile, some studies have discovered different results pertaining to the behaviour of the ownership structure and type with respect to firm performance. Arguably, the findings were negatively significant between the concentrated ownership and firm performance triggered by the manifestation of agency cost, therefore incurring more costs to the company (Cronqvist and Nilsson, 2003). Additionally, a similar result was found in the case of family ownership. However, several inconsistencies appeared when the dependent variable was switched from market-based to accounting-based (Mishra and Kapil, 2017).

In the context of Indonesia, the majority of companies are still classified as family-owned firms followed by government and foreign-controlled firms. The families who are controlling the companies have caused a non-transparency practice (Darmadi, 2016; Darmadi and Sodikin, 2013; Setiawan, Bandi, Kee Phua, and Trinugroho, 2016). According to Setiawan et al., (2016), the average of family-owned firms in Indonesia is around 57.3 to 68.6%. On the other hand, the concentrated ownership remains high with approximately between 47 to 49% average from the total public listed companies (Haron, 2018; Utama, et al, 2017).

Evidence from various cases of corporate governance failures on public listed firms in Indonesia need to be highlighted. The case of PT Cipaganti (CPGT) is the first case that needs to be brought to attention. CPGT is a transportation company in Indonesia, classified as a family-owned company. The ownership is concentrated only on the founder and a few of his relatives. The company was involved in many investment scams and was done by establishing a cooperation which aimed to finance their businesses by promising a high return. This owner was jailed and charged with 18 years of imprisonment and while the company is delisted from the stock exchange. It was then declared as bankrupt by the court (Detik, 2016).

The second case is by the most prominent family-owned business, Bakrie group that operated Bakrie Telecom (BTEL). The owner was affiliated to one of the biggest political parties in Indonesia. Between 2011 to 2012, the company faced difficulties in maintaining its services due to the fierce market competition in the sector. The owner further worsens the problem by running for the presidency in 2015 while the company was turmoil and was facing an unsolved issue regarding the Lapindo mud. The issue of Lapindo mud was caused by one of the group's companies. The Lapindo mud incident was the biggest operation of mine drill misconduct that caused a catastrophic sinking of the entire Porong region in East Java. The majority of the ownership for both companies, Lapindo and Bakrie Telecom was concentrated to the Bakrie family. Therefore, many corporate actions taken were affected by the personal interests of the family members. As a result, their stock price plummeted to 50 IDR (USD 0.0035) in 2012 and was subsequently suspended from the trade. Although the suspension was lifted in 2017, the stock price remains the same up until now (Kompas, 2018).

Based on the above-mentioned cases, it is evident that the current practice of corporate governance in Indonesia especially in business decisions and control needs a major reformation. If the above instances are not addressed properly, it could potentially harm the minority shareholders. Taking the case of Cipaganti and Bakrie Telecom for example, both companies were banned from the IDX trade. The mismanagement and poor decision-making contributed to the collapsed of the company's value affecting the price of the shares and its desirability. From the cases reviewed above, Prabowo and Simpson (2011) concur that family concentrated ownership companies in Indonesia affect the value of the firm in a significantly negative manner. The problematic corporate governance and ownership phenomenon in Indonesia has attracted many parties such as regulators, researchers and other stakeholders to come up with better solutions. The example of solutions proposed is the introduction of a new Act that regulates the role of the board of directors and consequences on the owners in terms of companies' default in 2007. It is especially crucial to revamp the current regulation now as Indonesia has been growing aggressively with a projected economy of USD16 trillion, behind China and India (Seasia, 2017). One of the initiatives that have been implemented is the issuance of a new guideline related to corporate governance by the financial authority in cooperation with the International Financial Corporation (IFC), which comprehensively discusses the practice of corporate governance in Indonesia (International Finance Corporation, 2014). It is crucial to have a proper guideline in terms of enhancing the practice of corporate governance to increase the confidence of foreign investment in Indonesia.

In addition, Indonesia has expressed a significant concern towards their development of Islamic Capital Market. Evidence from the Islamic capital market road map shows that the government has a plan to promote the Shariah compliance enhancement as well as the market expansion by 2019 (OJK, 2015). Currently, the implementation of the regulations is centred around the financial ratio and the nature of the business. The limited literature on the relationship between corporate governance that focuses on the board structure and ownership problem as well as the firm performance has motivated this research to explore further on this topic. It is also important to note that both CPGT and BTEL companies have been endorsed as Shariah compliant companies several times. Thus, this study aims to investigate the impact of corporate governance on the value of Shariah-compliant companies listed in Indonesia.

1.3 RESEARCH OBJECTIVES

Base on the problem statement, here we draw research objectives in this study.

1) To examine the firm performance based on market and accounting method across the Indonesia Shariah Stock Index (ISSI) firms.
2) To examine the effect of board structure and ownership concentration, ownership identity (family), and largest shareholder on the firm performance of Shariah listed firms in Indonesia.

1.4 RESEARCH QUESTIONS

1) How is the firm performance in Indonesia Shariah Stock Index (ISSI) measured by the market method and accounting method?
2) How is the effect of board structure, ownership concentration, ownership identity (family), and largest shareholder on the firm performance of Shariah listed firms in Indonesia?

1.5 SIGNIFICANCE OF THE STUDY

This study employs two different measurements of firm peformance, namely market-based method specifically Tobin's Q and accounting-based method using the Return on Asset (ROA) and the Return on Equity (ROE). The study emphasises on the combination of a quantitative panel analysis by extending its Islamic theories. As the population of Shariah compliant companies is large, a large number of data is employed to ensure a more accurate approximation. The research will also focus more on the concentrated ownership problems in Indonesia and to thoroughly analyse the behaviour of family and non- family firms. The outcomes of this study is hoped to benefit many stakeholders such as investors, shareholders and even academicians to understand better the condition of corporate governance and ownership in Indonesia. The findings from the analysis will also aid the government in terms of decision-making in the policy development related to the corporate governance and ownership for value creation.

1.6 ORGANIZATION OF THE STUDY

This research is structured in five chapters. Chapter 1 discusses the introduction of the study consists of the background of the study, problem statement, the objectives of the study, the research questions, the significance of the research, and the organisation of the study. Chapter 2 reviews the relevant literature and develops the research hypotheses. Chapter 3 explains further on the most related theories related to the study. Chapter 4 describes the research methodology used in this research and Chapter 5 analyses the results of the study. Lastly, Chapter 6 concludes the study by providing recommendations for future research.

CHAPTER TWO

LITERATURE REVIEW AND HYPOTHESIS DEVELOPMENT

2.1 INTRODUCTION

This study aims to investigate the relationship between corporate governance and ownership concentration effects on firm performance by using both market and accounting measurements on Indonesia's Shariah listed companies. Additionally, this research will focus on the size of the board of directors and the independent board which will be used as the board of directors' variables. As for the ownership section, part of the analysis will concentrate specifically on the ownership concentration behaviour, family ownership and the ownership identity. Subsequently, the relationships of all the domains will be discussed comprehensively from the Islamic perspective to enrich the insights of the outcomes. The goal of this chapter to provide clarity in each of the abovementioned element.

2.2 CORPORATE GOVERNANCE-A GENERAL OVERVIEW

Philosophically, there are many ways to define the actual meaning of corporate governance. Marie L'Huillier (2014) stated that the right definition of corporate governance depends on the theoretical dimension used in terms of explaining the corporate governance itself. The differences lie in the perspective taken to define corporate governance. If corporate governance is defined from the lens of the agency and stewardship theories, the focus will be on the human behaviour. While agency theory tends to minimise the losses of agency cost, stewardship theory aims to capitalise the limitation of trust for the benefits of the business. In contrast, other theories such as managerial hegemony, resource dependency and stakeholder do not emphasise on the personality of individuals who are involved in the corporate governance elements. Rather, they highlight the function of the board of directors as one structured entity that can be utilised for the purpose of business interest (Marie L'Huillier, 2014).

The earlier corporate governance practice is triggered by the recommendation of the Cadbury committee from the UK to strengthen the role and to promote the best practice of the management. Many ideas were suggested to ensure a successful implementation and to create a robust framework of functionality that works in every aspect of corporate governance (Cadbury, 1992). The goals of the model, claimed to be based on the stakeholder theory model aimed to increase the investors' confidence in British companies and to ensure the companies are value-maximisation oriented (Mees, 2015). In term of addressing the board's effectiveness, it is stipulated that the board has the power to control and lead the business entity. Therefore, a model from the combination of executive and non- executive directors led by a Chairman deemed to be a fitting model for a board structure. In order to mitigate the potentiality of conflict amongst the directors, the company needs to appoint independent directors whose interests are not directly relevant to the directors' conflict (Cadbury, 1992). The recommendation of the board model from the Cadbury's committee is believed to be the model recommended in the US at the beginning of the US corporate governance campaign (Mees, 2015).

Elucidating further on the responsibilities of the board of directors, the study conducted by Muller-Kahle, Wang, and Wu (2014) highlighted several important points that were taken from various literature. They believe that the roles of the board consist of firm monitoring, formulating the positions of top manager positions such as hiring, firing and evaluating them as well as to structure the remuneration. The board is also in charge of strategic decision-making and in some circumstances, to provide