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The Effect of Corporate Governance on Capital Structure in Public Listed Companies in Indonesia

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Abstract

This research examines the effect of corporate governance on capital structure decision in public listed companies in Indonesia. To describe corporate governance, the proxies used are the existence of independent commissioners in board of commissioner (BOC), audit committee possessing financial knowledge, audit committee's frequency of meeting, Big 4 auditors, ownership concentration, managerial ownership, and CEO tenure. The proxy for capital structure is debt ratio.

This research uses Kompas 100 index as per August 2012 – January 2013 as the base of the sample firms with exclusion of financial firms, banks, and insurance companies. Financial data will be collected from companies' annual report in the period 2007-2011. The sample firms exclude those that do not have annual report during the sample period. The method of analysis employed is multiple regression analysis. The data is subjected to multicollinearity test.

This research finds that some variables of corporate governance do have relationship with capital structure. The presence of independent commissioner in BOC and the meeting frequency of audit committee are significantly negatively associated with debt ratio. Meanwhile, the presence of financial experts in audit committee is significantly positively associated with debt ratio. Other measures of corporate governance are not significant in their influence on debt ratio.

This research concludes that some corporate governance factors do affect capital structure as the answer to the question whether corporate governance affects capital structure in Indonesian public listed companies or not. Interestingly, those significant corporate governance variables are all parts of BOC which is the most important element of corporate governance. Hence, BOC affects capital structure in Indonesian public listed companies.

Keywords: Capital structure, Corporate governance, Agency theory, Debt ratio.

1. Introduction

Capital structure is really important for a company (Chen, Cheng, He, and Kim, 1997) as it will affect the financial health of a company (Heng, Azrbaijani, and San, 2012). It is about how a company chooses between debt and equity to finance its business activities ("Capital Structure," 2013). There are consequences in choosing more debt or more capital. Choosing the wrong combination of capital structure can lead to financial distress (Heng et al., 2012). According to the famous propositions

suggested by Modigliani and Miller, there is tax advantage assumed in leverage; this what makes debt attractive and is a useful capital structure strategy and that its tax benefit actually can increase the value of firm. In fact, pure theory leans towards all debt capital structure (Miller, 1995, p. 128), but that is an extreme case. *However*, there is increasing bankruptcy costs implied in debt as well as higher return required by shareholders, meaning it is becoming riskier for them (Pae & Choi, 2011).

The trade-off theory states that there is trade-off between bankruptcy costs and tax advantages of debt (Burgman, 1996; Chen et al., 1997). The managers of a firm may be tempted by the advantage offered by leverage and may use it abusively at the expense of shareholders because it is shareholders who actually bear the risks. This may be done because managers often make decisions in their own self-interests that may be different to that of shareholders, which in many cases leads to shareholders being disadvantaged. This brings the discussion to agency problem.

Agency problem is about conflict of interest happens between shareholders and managers of a company ("Agency Problem," 2013) that arise because there is separation of ownership and control (Gill, Biger, Mand, and Shah, 2012; Heng et al., 2012; Islam, Islam, Bhattacharjee, and Islam, 2010; Ongore & K'Obonyo, 2011). Managers are supposed to act in the best interest of the shareholders because shareholders, as the owners of the company, entrust the day-to-day control to managers. The problem happens because managers also have their own interest which commonly are protecting their position and maximizing their own compensation. It is possible for managers to pursue their own self-interest because asymmetric information exists in which managers know more information about the company than shareholders which makes it possible for managers to take advantage of shareholders' lack of knowledge. This has made it not good for shareholders and that is why shareholders are often being the victims in the agency problem ("Asymmetric Information," 2013; "Principal-Agent Problem", 2013).

The effect of agency problem could span as far as damaging the economy like the corporate failures that happened in the past (i.e. Enron and WorldCom) as well as the recent global economic crisis that happened back in the year 2008 (Pae & Choi, 2011). When Enron fell down back in the year 2001, its share price experienced a free fall from \$84.87 to just \$4.55 in the same year. This happened because Enron had inflated its profits by \$600 in year 1997-2001 than what had been previously reported and hidden some of its expenses ("Crisis Fears Hit Enron Shares," 2001). It was obvious in the case of Enron that managers were the ones who hide the information; this was a situation of information asymmetry; and when the share price shrank, it was obvious that shareholders were the ones who were deeply hurt.

To avoid the same misfortune from ever happening again, there is a need for some kind of mechanism to monitor managers to do what they were supposed to do and act ethically, to protect investors, and to make information more transparent for company outsiders. This monitoring mechanism is realized in the form of corporate governance that serves as a tool for reducing agency problem (Heng et al., 2012; Islam et al., 2010; Ongore & K'Obonyo, 2011; Pae&Choi, 2011). Corporate governance is a system that aims at aligning the interests of managers and that of shareholders ("Corporate Governance," 2013). It serves as a shareholder protection program.

Results in a research done by Heng et al. (2012) had shown that the size of the board and the presence of independent non-executive directors on the board, which were components of corporate governance, had significant negative and positive correlation respectively with debt to asset ratio. This has shown that corporate governance plays role in determining the capital structure decision of a company.

Because of the imposed agency problem, therefore, there is a need for companies to find suitable capital structure decision consisting of suitable proportion of debt and capital. It is so that the firm value can be maximized but the capital structure does not carry too much debt that is potentially harmful for shareholders. An optimal capital structure is the one that minimizes the cost of capital yet reaping more wealth and value for shareholders (Gill et al., 2012). To reach this goal, corporate governance is a tool to influence suitable capital structure decision being made by company managers. In fact, corporate governance, serving its role as supervisor, tries to make sure that suitable capital structure decision is being made by company managers. Therefore, corporate governance has an effect on capital structure (Gill et al., 2012).

Many past literatures distinctively have discussed the relationship between corporate governance and capital structure, corporate governance and agency costs, and agency costs and capital structure. From these past studies, the author has come to an opinion that overall it is about corporate governance

affecting capital structure decision. That effect can be direct and indirect. Direct effect means that corporate governance affects directly on the capital structure choice by itself while indirect effect means that corporate governance will affect agency problem, as it is designed to do so, that will eventually affect capital structure choice (Chen et al., 1997). Agency costs themselves are the internal costs that must be incurred, because of the rise of agency problem, to monitor the managers in order to make sure that they are making decisions regarding the company in the best interests of the shareholders (“Agency Costs,” 2013).

Studies regarding the relationship between agency problem, corporate governance and capital structure have been conducted in several countries including Korea, Tunisia, Malaysia, India, Bangladesh, U.K. Hence, this research tries to find the effect of corporate governance on capital structure in public listed companies in Indonesia. Thus, the research question in this study is to find the answer: *Does corporate governance affect capital structure in Indonesian public listed companies?*

2. Literature Review

Capital structure is consisted of debt and equity. They determine the amount of financing of a company. They also determine the company’s value when the value of equity is summed up with the value of debt. Debt is considered less risky than equity; as a result, it is cheaper than equity. Since debt is cheaper than equity, the resulting cost of capital is lower than it would have been if the firm is unlevered, making the cost of financing cheaper as a whole, thus safer as well for both the company and investors. This has been the proof that there is advantage in having debt and the advantage comes from the tax incurred on the debt. However, at the same time the cost of equity is actually getting higher as more debt is added to the firm’s capital structure. At some point, the advantage gained through debt will be offset by the increase in the firm’s cost of equity. Therefore, too much debt is also not good. An optimal capital structure is when the level of debt is just right that the company is gaining tax advantage as its highest point and that the cost of capital is in its lowest point in which adding more debt will start to increase the cost of capital again. At this point, the company is minimizing its cost optimally and the firm value is at its peak, thus maximizing shareholder wealth (Vernimmen, Quiry, Dallochio, Fur, and Salvi, 2011, p. 639). This is the ideal condition of capital structure.

There is no one right answer of the exact amount of debt and equity should be employed to form an optimal capital structure. There are guidelines though on what kind of companies should use more or less debt. Chen et al. (1997) mentioned that firms with higher growth opportunities should use less debt while this argument was complemented by Fatma & Chichti (2011) who mentioned that firms with lower growth opportunities should use more debt to control agency conflict resulting from high level of free cash flow that tended to be used lavishly by managers instead of creating additional shareholder value. Myers (1995, pp. 135-143) provided a checklist consisted of three items: taxes, risk, and asset type. According to this checklist, those companies with consistent profits, less dependent on intangible assets and growth opportunities and are basically safe companies are eligible to take more debt. Conversely, those companies that are risky, can utilize tax advantage in other ways than merely obtaining from interest payments on debt such as tax exemption on loss and non-interest tax shields like depreciation and amortization expense, have more holdings in intangible assets than in tangible assets, and are rapidly growing are suggested to not take debt financing.

In many literatures, the measure of capital structure is usually proxied by debt ratio, or also sometimes referred to as leverage that is defined as “the amount of debt used to finance a firm’s assets” (“Leverage,” 2013, Definition of ‘Leverage’ section, para. 2). Debt ratio itself can be either debt-to-asset ratio where debt is compared with assets, or debt-to-equity ratio where debt is compared with equity. Both ratios show how much debt a company has although the context is slightly different. The exact formula that is used in academic studies varies between literatures. Chen et al. (1997) used debt-to-equity ratio: long-term debt divided by long-term debt and market value of debt. Exactly the same formula was also used by Burgman (1996), only it referred the formula as leverage. Fatma & Chichti (2011) also referred the formula they used as leverage: book value of long-term debt divided by book value of total assets. Meanwhile Heng et al. (2012) just simply used debt-to-asset ratio. The use of debt ratio or leverage was also supported by many other past studies summarized in Gill et al.

(2012). All in all, the use of debt ratio serves as a gauge of the choice between more debts or more equity is being used as financing.

Among the many literatures that were using debt ratio as their only proxy for capital structure, Pae & Choi (2011) uniquely used cost of equity capital instead. It was because its focus was also slightly different than other literatures in general. Instead of focusing on how much debt a company was employing with certain corporate governance quality, it was focusing on how good corporate governance was actually valued by investors. The result found was that indeed good corporate governance was acknowledged and appreciated well by investors that they lowered their required rate of return. That indicated that investors gave value premium to those companies. In support of findings discussed by Pae & Choi (2011), Vernimmen et al. (2011, p. 817) stated “the investors surveyed stated that they would be prepared to pay more for shares in a company with a good system of corporate governance in place”. As a result, companies with good corporate governance will become more competitive in the global market. (Pae & Choi, 2011).

This provides information and confirmation that corporate governance does influence capital structure. Good corporate governance will result in capital structure choice being optimal, that is minimizing risks yet maximizing shareholder value.

Corporate governance in Indonesia is not as sophisticated as in many developed countries and is still lacking a lot. It has low standard of disclosure and transparency and lacks in areas such as “accountability to shareholders, board processes, auditing, and compliance” (Siregar & Utama, 2008, p.3). Siregar & Utama in 2008 found that independent boards and the formation of audit committee in Indonesia were there just for the sake of obeying the rule. Waworuntu, Hermawan, and Hokardi in 2012 still found that both organs were established by corporations in Indonesia just for compliance sake and not for earnest monitoring purposes.

The terminology used in Indonesia is Board of Commissioners to refer to what internationally recognized as Board of Directors, who are the oversight board. The Board of Directors in Indonesia refers to the top executive management of the company such as CEO, CFO, COO, and any other chief officers. This system is referred as the two-tier system (Tumbuan, 2005).

The complete set of corporate organs in Indonesia, mentioned in order of highest to lowest in authority, is consisted of general meeting of shareholders (GMS), BOC, and BOD. Between the three of them, the one who runs the company in daily basis is BOD. BOD is also the one who is responsible in the makings of financial statement of the company (Achmadi, Kandar, and Reid, 2010). They are the ones who are being oversought by the whole corporate governance system, and their way of producing financial statement is one the major reason of the establishment of corporate governance.

GMS points out the members of BOC and BOD. They have the authority to approve and dismiss those members by holding votes. They do not involve in the day-to-day managing activities of the company. They also have the utmost authorities that are delegated to neither BOC nor BOD (Achmadi et al., 2010).

BOC is the one who is demanded to be independent as have also been discussed earlier. They are the oversight board, the ones doing the supervisory role. They monitor BOD, advice BOD on the company’s operational or other matters, and then report to GMS regarding the actions taken by BOD on the day-to-day operations of the company. However, they are not intended to dictate the BOD on what to do, leaving BOD with enough room for managerial discretion to creatively run the company (Achmadi et al., 2010; Fatma & Chichti, 2011). The Indonesian corporate law year 2007 stipulates in article 108 the third paragraph that BOC is consisted of one or more member. Same goes with BOD in article 92 the third paragraph (“Undang-Undang Republik Indonesia,” 2007).

Public listed companies in Indonesia have to have at least audit committee as one of the special committees under the BOC. Other special committees can be formed depending on needs of the company itself as governed by National Committee for Governance (“Pedoman Umum Good Corporate Governance Indonesia,” 2006). The audit committee “should at least have three members” (Siregar & Utama, 2008, p.5), is lead by an independent member of BOC, should at least have one member who has financial expertise, and the rest of the members can be comprised of commissioners and/or independent external professionals (“Pedoman Umum Good Corporate Governance Indonesia,” 2006; Siregar & Utama, 2008). Special committees other than audit committee can be nomination committee, remuneration committee, risk management committee, and corporate governance committee. All special committee are to be led by independent commissioner and can have members

comprised of commissioners and/or independent external professionals (“Pedoman Umum Good Corporate Governance Indonesia,” 2006).

There are many previous literatures that studied the relationship between corporate governance and capital structure which all are represented by debt ratio or leverage. As summarized and quoted in Gill et al. (2012), findings regarding the relationship studies were really varied. Some found negative association between board size and debt ratio, and some others found positive association instead. Some found CEO duality to be negatively correlated with capital structure, some found the exact opposite, and some others found no significant relationship between the two variables. Nonetheless, all this shows that corporate governance, proxied by BOC variables, does have significant effect on capital structure.

So, there have been many previous researches that studied the relationship between corporate governance and capital structure. They found that corporate governance affects capital structure. The findings of previous researches in this regard were greatly varied and many were contradicting each other in terms of positive or negative relationship between corporate governance and capital structure. For this matter, the author chooses to believe that when the corporate governance gets better, the choice of financing mix in the capital structure will be better for shareholders, as corporate governance is designed for the managers of the company to be working more ethically and making decisions on the behalf of shareholders. This is shown by negative relationship between corporate governance and capital structure. The reason is if corporate governance gets better, the capital structure should contain less bankruptcy costs which are detrimental for shareholders, thus making the capital structure choice safer for the shareholders. This can be achieved by having less debt in the capital structure as debt or leverage is a representation of bankruptcy risk (Abbott & Parker, 2000).

This conceptual thinking is arisen from the work of Adnan, Rashid, Meera, and Htay (2011) who argued that corporate governance is there in the first place to lessen firms’ risk. Risk, as have been written in above paragraph, is embedded in debt (Abbott & Parker, 2000). Ramadan (2012) also said that leverage does always mean risk. This conceptual thinking is also built upon the work of Pae & Choi (2011) who argued that companies with more comprehensive corporate governance and better business ethics have premium value in the eyes of shareholders. The premium value is given by shareholders in the form of lower cost of equity. By theoretical calculations, lower cost of equity will lower cost of capital. Lower cost of capital will result in higher firm value. Lower cost of equity can be achieved if there is less debt in a company’s capital structure. Besides, the meaning of lower cost of equity is that shareholders feel safer, hence they lower their required rate of return as opposed to higher cost of equity where shareholders feel they need more return for bearing more risks. Therefore, the author makes a generalization that all proxies that are considered as good characteristics of corporate governance are expected to lower the amount of debt in capital structure. This agrees with the work of Wen, Rwegasira, and Bilderbeek (2002) that said that there is a propensity to pursue lesser financial leverage with better corporate governance. This is shown in all hypotheses developed in this research.

According to Heng et al. (2012), in measuring BOC, the features that represent BOC are size of the board, CEO/Chair duality, and the presence of independent non-executive commissioners on the board. The three proxies of BOC were also used in the study of Waworuntu et al. (2012). In the Heng et al. (2012), it was hypothesized that the board size was negatively related with debt ratio that is representing the company’s capital structure. This is easily understood as the bigger the size of the board is normally assumed to be a better condition of corporate governance, thus lead to lower debt ratio that conveys lower bankruptcy costs and lower risks imposed to shareholders. It was also hypothesized that the presence of independent non-executive commissioners in the board was positively correlated with the firm’s capital structure which was still represented by debt ratio. This time, it may be seemed contradictory to the previous hypothesis. The reasoning provided in the literature explained that when the company was being monitored effectively, it would increase the creditworthiness of the firm so that it could afford higher debt. However, the findings in the journal did prove that both hypotheses were accepted significantly. On the other hand, Adnan et al. (2011) found that proportion of independent commissioners is negatively related with risk.

The discussion on the Board of Commissioners above has led to the following hypothesis:

H1: *Presence of independent non-executive commissioners in the board is negatively related with debt ratio*

Some of the features made as proxies of audit committee overlap with other sub-items under corporate governance discussed in this research such as board size and management ownership. Islam et al. (2010) provided two variables that only belong to audit committee which were size of the audit committee and auditor. Abbott, Parker, Peters, and Raghunandan (2003) suggested more proxy variables that were audit committee independence, audit committee at least having one member with financial expertise, and meeting frequency of audit committee, which all determined the quality of audit committee. The study compared audit committee characteristics with audit fees and admitted that audit committee was within the big umbrella of corporate governance, with the result of positive relationship between audit committee and audit fees. The positive relationship meant when audit committee become better in quality, there would be more demand for more comprehensive auditing process, which meant more time would be consumed in the auditing process, to really ensure fair financial reporting which would drive higher audit fees. This leads to the idea that the better the quality of audit committee, the better the corporate governance becomes, and when corporate governance is enhanced, lower debt is the consequence.

The variables that were showing significant results in the research of Abbot et al. (2003) were the independence of audit committee and financial expertise possession of audit committee. Although the name is audit committee in which its duty is to oversee the management in the field of accounting and auditing, the truth is that the members' backgrounds are varied that they may not possess any accounting or financial skills at all. That is why there is a notion that the audit committees that possess financial expertise must excel compared to those who do not.

Persons (2009) emphasized the importance of audit committee size and audit committee meeting frequency in her research finding. She recommended that audit committee of larger size i.e. more than three members and that conducted meetings of at least four times in a year tend to release earlier voluntary disclosure that was associated with better corporate governance and ethics. Audit committee meeting frequency denotes the level of activeness and diligence of the audit committee (Abbott et al., 2003; Abbott & Parker, 2000; Persons, 2009).

Therefore, the following hypotheses are developed:

H2: Audit committee with financial expertise is negatively related with debt ratio

H3: Meeting frequency of audit committee is negatively related with debt ratio

The selection of external auditor is of importance in determining audit quality that will eventually affect cost of capital (Abbott & Parker, 2000). Audit quality is defined as the possibility that material misstatement in the financial statement will be discovered and reported by the auditor (Abbot et al., 2003; Abbot & Parker, 2000; Siregar & Utama, 2008). Abbott & Parker in their study argued that industry specialized auditor provided better audit quality compared to non-industry specialized auditor. The auditor who is non-industry specialist has higher tendency to give management more room to do earnings management as they do not have the in-depth understanding on the specific business the company is involved in. This indicates that auditor selection is also an important determinant of corporate governance.

The best representation for auditors with industry specialized knowledge is the Big 4 auditors. It is acknowledged that in the finding of Siregar & Utama (2008), they concluded that Big 4 auditors were not a good description of audit quality in Indonesia. They suggested that audit fee and audit hours may perform better for research on audit quality in Indonesia. However, those data were not available on annual reports. Moreover, the emphasis in this research is on the industry specialization character of audit quality that is likely to be obtained in Big 4 auditors. Because these audit firms are big, they have the resources to provide auditors that are industry specialist rather than the non-Big 4 auditors. Besides, one of the reasons why the previous Big 6 auditors merged was to obtain industry specialization knowledge differentiation (Abbott & Parker, 2000). Hence, the following hypothesis is made:

H4: The use of Big 4 auditors is negatively related with debt ratio

Besides BOC and audit committee, share ownership also plays role in determining corporate governance. Who owns the shares and how much they own it do matter as they can influence the

company's decision making through shareholders' voting rights. According to Ongore & K'Obonyo (2011), it identified several ownership identities such as government ownership, institutional ownership, foreign ownership, and manager (or also called *insider*) ownership, and identified two ownership forms which were concentrated ownership and diverse ownership. One of its main arguments was that concentrated ownership should indicate better corporate governance reflected in better corporate performance because shareholders who owned blocks of shares would worry more about their wealth in that company than the minority shareholders, as a result these blockholders would put stricter monitoring onto BOD through BOC as an attempt to reduce agency conflict. If the concentrated ownership was hypothesized to be better in determining corporate governance, that automatically put diverse ownership in the opposite end of the argument. This argument was theoretically agreed by Fatma & Chichti (2011).

However, the finding of the research of Ongore & K'Obonyo (2011) rejected its own hypothesis regarding concentrated ownership. They found that instead of concentrated ownership, it was dispersed ownership that resulted in higher corporate performance which was associated with good corporate governance. This finding was also emphasized by the finding of Alba et al. (1998) and Du & Dai (2005), both as cited in Gill et al. (2012), and also the finding of Al-Deehani & Al-Saad (2007), Driffield et al. (2007), and Pindado & De La torre (2005), all three of them are as cited in Fatma & Chichti (2011). They found that the more concentrated the share ownership was, the more leverage there was.

Ongore & K'Obonyo (2011) also argued that managerial ownership should determine better corporate governance as one of the most straightforward ways to align the interest of managers with that of shareholders, therefore reducing agency conflicts between them. By owning some of the company shares, managers get to feel the worries and interests of shareholders. This was also supported by the finding of Fatma & Chichti (2011) and McKnight & Weir (2009) who found that managerial ownership reduced agency costs, however was opposed by Islam et al. (2010) as it stated that having shares owned by managers decreased the tendency of companies having audit committees who were totally independent. This could be the downside of having managerial ownership as a form of control.

Therefore, according to the findings of Ongore & K'Obonyo (2011), the good characteristics of corporate governance include dispersed ownership form, managerial ownership, institutional ownership, and foreign ownership. Based on that, the following hypotheses are formed:

H5: *Concentrated ownership is positively related with debt ratio*

H6: *Managerial ownership is negatively related with debt ratio*

While the proxies all discussed above represent BOC, GMS and one special committee from BOC which is audit committee, BOD has left to be covered. One of the principles stated by the National Committee for Governance ("Pedoman Umum Good Corporate Governance Indonesia," 2006) for BOD to run well is that the members are expected to be professional, that is to have integrity, the skills needed to run the company, and experience. One variable representing experience is CEO tenure in which how long the CEO has remained in his/her position (Rakhmayil & Yuce, 2009; Shakir, 2009).

Rakhmayil and Yuce (2009) conducted a study on CEO qualifications, including CEO tenure, and its effect towards capital structure proxied by leverage. They interpreted that the longer the tenure meant that the CEO had more experienced and thus was of higher competence. Their research result was that CEO tenure was significantly negatively related with leverage. The explanation was that the more experienced the CEO was, the more cautious he/she was of the risk of bankruptcy lied in debt and that the more debt was used, there would be less capacity for the company to borrow in times where financing is crucial. In support with the work of Rakhmayil and Yuce (2009), Gill et al. (2012) in their summary of previous literature's findings listed some proves of negative relationship between CEO tenure and capital structure.

Shakir (2009) on the other hand discussed that CEOs are experiencing two phases in their term of office which is divided by a benchmark of 10 years. The first ten years are young tenured CEOs. They are in the phase of building up their reputation and adapting to the companies' environment so they strive to prove themselves. In effect, they do well for companies' performance. Then as they sit

longer in the CEO position, they begin to feel more relaxed and lenient with their work or they become too absorbed in their own ambition that they refuse to accept changes in the environment. So the overall quality given by CEO tenure is more like an inverted U shape.

Building up from the information regarding CEO tenure, the author arrives at the following hypothesis:

H7: *CEO tenure is negatively related to debt ratio*

There are two control variables that this study is proposing; they are firm size and profitability. Firm size in many literatures is predicted to give influence on capital structure decision and that is represented by positive relationship with debt ratio. Advocates of this thought are like Karadeniz, Kand, Iskenderoglu, and Onal(2011),Lim (2012), and Nguyen& Ramachandran (2006). According to these sources, the reason for the positive relationship between firm size and leverage is that as the business gets bigger, the company will stand on its feet more firmly as they have more stable stream of cash flows. Stable companies can afford to incur more debt. Bigger companies also tend to be more diversified which reduces risks so they are more immune to bankruptcy rather than the smaller ones. Asymmetric information also plays role in determining the capability of firms to obtain debt financing as part of their capital structure decision. Bigger companies incline to disclose more information about themselves, making them more transparent compared to smaller firms. This results in easier access to debt financing for these larger firms. For these reasons, hence the following hypothesis is formed:

H8: *Firm size is positively related with debt ratio*

The next control variable is profitability. The discussion of profitability in its relation to capital structure is based on pecking order theory (Lim, 2012; Nguyen & Ramachandran, 2006). The theory states that companies will try to survive internally before they finally feel the need to get financing externally. The theory then predicts that profitability is negatively associated with firm leverage. As companies earn more profits, they have more internal resource to use for investment and growth purposes and so they use it. In effect, less debt is used and more retained earnings are used instead.

However, the actual findings on the relationship between profitability and capital structure always vary (Lim, 2012; Nguyen & Ramachandran, 2006). An alternative argument to what have just been discussed in the above paragraph is that more profits earned should make companies able to make more loans.

This research chooses to take the first argument as a hypothesis as lower amount of debt will potentially lower the risk of default:

H9: *Profitability is negatively related with debt ratio*

3. Methodology

This research will use multiple regression to determine the relationship between corporate governance and capital structure. The equation will be as follows:

Equation 3.1.

$$\text{Debt} = a_1 + b_1\text{INDBOC} + c_1\text{ACEXP} + d_1\text{MEET} + e_1\text{BIG4} + f_1\text{OWNCONC} \\ + g_1\text{MANOWN} + h_1\text{CEOTENURE} + i_1\ln\text{SIZE} + j_1\text{ROE} + \varepsilon_1$$

There will be nine independent variables; seven of them are corporate governance elements, and two of them are control variables. The dependent variable is debt ratio to represent capital structure. The variables, their notations, and their measurements are summarized as follow:

Table-3.1. Variables and Measurements

Variable Type	Variable category	Variable proxy	Variable measurement	Source
Dependent	Capital structure	Debt ratio (DEBT)	Book value of long term debt : book value of total assets	Fatma & Chichti, 2011
	Corporate governance	Independent commissioners in BOC (INDBOC)	Number of independent directors divided by the whole number of board members	Heng et al., 2012
	Corporate governance	Audit committee with financial expertise (ACEXP)	Dummy variable: score of 1 if the audit committee has at least one member having financial expertise, 0 if no member possess financial expertise	Abbot et al., 2003
	Corporate governance	Audit committee meeting frequency (MEET)	Number of audit committee meetings in a year	Abbot et al., 2003; Persons, 2009
	Corporate governance	Big 4 auditors (BIG4)	Dummy variable: score of 1 if when big 4 auditor is used, otherwise 0	Abbott & Parker, 2000
	Corporate governance	Ownership concentration (OWNCONC)	Percentage of share owned by the largest shareholder in a firm	Fatma & Chichti, 2011; Ongore & K'Obonyo, 2011
	Corporate governance	Managerial ownership (MANOWN)	Amount of shares owned by Directors and members of BOC : total of assets	Fatma & Chichti, 2011; Ongore & K'Obonyo, 2011
Independent	Corporate governance	CEO Tenure (CEOTENURE)	Number of years holds CEO position	Rakhmayil & Yuce, 2009; Shakir, 2009
	Firm size	Total assets (SIZE)	The natural logarithm of total assets	Fatma & Chichti, 2011; Lim, 2012; Ramadan, 2012
			Net Income: shareholders equity (excluding preferred stocks)	Almazari, 2012; Fathi, Zarei, and Esfahani, 2012; Vintila & Gherghina, 2012
Control	Profitability	ROE		

The sample firms were obtained from Kompas 100 as per August 2012 – January 2013. From 100 companies listed in the index, 16 companies were excluded from the sample because they are financial firms, banks, and insurance companies. These firms were not included in the sample because they were regulated differently to other common corporations (Fatma& Chichti, 2011; Heng et al., 2012; McKnight & Weir, 2008). Then, another 41 companies were excluded from the sample because they did not have complete annual reports during the five year period, i.e. 2007-2011, examined in this research. From the total of 43 companies with complete set of annual reports, three companies were further excluded because they did not disclose one variable that was needed in this research, which

was the variable audit committee meeting frequency. Then three further companies were also aborted from being the research sample because they did not have audit committee at all in the year 2007. This meant that they were not compliant to the Indonesian rule of corporate governance as it was stated that each public listed company should at least have audit committee as its special committee under Board of Commissioners (BOC) (“Pedoman Umum Good Corporate Governance Indonesia,” 2006). After eliminating these companies that were not eligible to be included in the research sample, the total of 37 companies were included in the final sample. That made up 185 annual reports to be analyzed in total (37 companies times five annual reports obtained from five year period that is 2007-2011).

4. Discussion Analysis

Table-4.1. Descriptive statistics

Variables	Mean	Std. deviation	Min	Max	Mode
Debt	0.1474989	0.1534255	0	0.6033169	0
INDBOC	0.4249583	0.103694	0.2	0.8	0.4
ACEXP	0.93	0.256	0	1	1
MEET	10.08	9.358	1	72	4
BIG4	0.6	0.491	0	1	1
OWNCONC	0.4656923	0.23911	0.0505	0.96	0.422 ^a
MANOWN	0.0041822	0.020446	0	0.1553466	0
CEOTENURE	5.0869369	3.4089678	0.0833	15	2 ^a
lnSIZE	29.730777	1.187795	26.31719	32.66485	26.317 ^a
SIZE (Rp)	1.602E+13	2.353E+13	2.688E+11	1.535E+14	268790167421 ^a
ROE	0.1946586	0.2736966	-0.99488	2.66705	-0.99488 ^a

^a multiple modes are there but only the lowest figure is shown

The mean amount for debt ratio is 14.75%. This number is smaller compared to the mean amount of debt ratio in Malaysia within study period of 2005-2008 which is 44.39% (Heng et al., 2012) and that in Tunisia which is 20% during the study period of 1999-2008 (Fatma & Chichti, 2011), however, is larger compared to that in Jordania which is 6.14% in the years 2001-2011 (Ramadan, 2012) and 12% in Turkey from year 1993 to 2002 (Umutlu, 2010). So, it seems that Indonesia is in the middle in terms of firm leverage. The mode 0 of leverage reveals that Indonesian companies are still using internal financing most of the time and does depend on organic growth.

The mean figure for independent commissioner in the BOC is 42.50% with a mode of 40%. This reveals that most public listed companies in Indonesia have already been compliant with the Indonesian rule of corporate governance that states that 30% or more of the board size must be independent commissioner (Siregar & Utama, 2008).

On average, public listed companies in Indonesia in this research have audit committee consisted of at least one person with accounting or finance expertise. This shows that mostly, Indonesian public listed companies have been compliant to the Indonesian corporate governance rule regarding audit committee (“Pedoman Umum Good Corporate Governance Indonesia,” 2006; Siregar & Utama, 2008).

The average for audit committee meeting frequency is 10 times in a year. This aligns with the benchmark set by Abbott et al. (2003) and Persons (2009), that is four meetings in a year at least.

60% of the sample firms’ annual reports in this research are audited by Big 4 auditors. This result gives information that although they are public listed companies, there are still many of them that are not using Big 4 auditors as their independent external auditors. Nonetheless, mostly these companies do select Big 4 auditors as their external auditors.

The mean for ownership concentration is 46.57%. According to Indonesian law of public listed companies, it is stated in clause 79 verse 2 and clause 138 verse 3 that share ownership of 10% or more has been categorized as controlling owners (“Undang-Undang Republik Indonesia,” 2007). Therefore, according to this rule, on average, public listed companies in Indonesia have concentrated ownership structure.

The mean figure for this managerial ownership is 0.4182% which is very few. This conveys that managerial ownership is not popular in Indonesian public listed companies and hence may not be utilized that much for aligning the interest of managers with that of the shareholders. It may also mean that most companies in Indonesia are family-owned. As Siregar & Utama (2008) and Reddy (2009) say that it is culturally common for companies to be family-owned in Asian countries and in developed and developing countries. Such countries are like India, Indonesia, Japan, Thailand, Korea, Malaysia, Spain, Turkey, Egypt, and Belgia.

CEOs in Indonesia are relatively young. The average is only 5 years and the maximum years of tenure reached is 15. In Singapore, the average CEO tenure is 6.73 years with the longest CEO reaching 31 years reported in 2001 by Mak & Li (as cited in Shakir, 2009). Another neighboring ASEAN country is Malaysia. The average CEO tenure there is 8.9 years during the study period of 1999-2005 and a maximum of 42 years (Shakir, 2009).

Table 4.1 shows two different types of result for size. *lnSIZE* is showing the result in logarithm form while *SIZE* is showing the result in currency form, that is in rupiah. The average size of Indonesian public listed companies in this research is Rp16.019.330.133.300,19 or 29.73 in logarithm figure. This is bigger compared to the logarithm figures reported by Fatma & Chichti (2012) for Tunisia with the mean size of 10.963 in years 1999-2008 and that reported by Ramadan (2012) for Jordania with the mean size of 16.39 in years 2001-2011.

The average profit that the Indonesian public listed companies are generating in this study is 19.47% return of the shareholder's equity. This figure shows a more profitable state compared to the mean figure for ROE of -20% in U.S. in year (Vintila & Gherghina, 2012) and the mean value of 10.9% of ROE in Korea in study period of 2004-2008 (Pae & Choi, 2011).

Table-4.2. Regression result of debt ratio as dependent variable

Variables	Coefficient	P-value	VIF
constant	-1.429	0	
INDBOC	-0.184	0.089	1.131
ACEXP	0.118	0.006	1.075
MEET	-0.003	0.018	1.382
BIG4	-0.021	0.356	1.156
OWNCONC	0.03	0.563	1.354
MANOWN	0.01	0.986	1.318
CEOTENURE	0.004	0.253	1.284
SIZE	0.053	0	1.442
ROE	-0.059	0.183	1.309
$R^2 = 0.181$			
Adj. $R^2 = 0.138$			
F-stat = 4.284			
F-sig = 0.000			

The result of adjusted R^2 shows that the regression model employed in this research explains 13.8% of the change in debt ratio. The F-test result for this model is significant under 0.05 significance value. The model has no problem with multicollinearity. Altogether, the result of the regression analysis forms the following regression equation:

Equation 4.1.

$$\begin{aligned} Debt = & -1.429 - 0.184.INDBOC + 0.118.ACEXP - 0.003.MEET \\ & - 0.021.BIG4 + 0.03.OWNCONC + 0.01.MANOWN \\ & + 0.004.CEOTENURE + 0.053.lnSIZE - 0.059.ROE \end{aligned}$$

Table-4.3. Statistical test summary

V a r i a b l e	Hypothesis	Expected Sign	Actual Sign	S i g n i f i c a n c e
I N D B O C	H 1	-	-	0.089; accept H1***
A C E X P	H 2	-	+	0.006; reject H2*
M E E T	H 3	-	-	0.018; accept H3**
B I G 4	H 4	-	-	0.356; reject H4
O W N C O N C	H 5	+	+	0.563; reject H5
M A N O W N	H 6	-	+	0.986; reject H6
C E O T E N U R E	H 7	-	+	0.253; reject H7
S I Z E	H 8	+	+	0.000; accept H8*
R O E	H 9	-	-	0.183; reject H9

* 0.01 significance level, 99% confidence level

** 0.05 significance level, 95% confidence level

*** 0.1 significance level, 90% confidence level

The p-value for independent commissioners in BOC is 0.089 and its Beta value is -0.184. So there is a significant negative relationship between the presence of independent commissioners in BOC and debt ratio in a company's capital structure. This is just as expected. This result supports the finding by Adnan et al. (2011) who discovered that higher proportion of independent commissioners resulted in lower risk. They quoted in their work that independent element of corporate governance portrayed in BOC was found to help lower bond yields, higher bond ratings, and thus lowers the risk of the firm in general (Bhojraj & Sengupta and Brick & Chidambaran as cited in Adnan et al., 2011).

The p-value for audit committee members possessing financial expertise is 0.006 and its Beta value is 0.118, so its relationship with debt ratio is significantly positive. This result rejects the author's hypothesis. One explanation for this result is that better quality in corporate governance will make the company more creditworthy in the eyes of lenders as is advocated by Heng et al. (2012). In effect, it would be easier for the company to obtain financing from debt. In the literature, this was shown by positive relationship between the corporate governance element, which was independent commissioners in BOC, and capital structure. Audit committee is within BOC anyway, so this finding of Heng et al. (2012) can be applied to the finding here regarding audit committee with financial expertise. Another reason to this finding is in the light of when the audit committee is actually not performing well, contrary to the first reason that assumes that audit committee is indeed doing their job. If the audit committee exists and is comprised of financial experts just for the sake of formality (Siregar & Utama, 2008; Waworuntu et al., 2012), then it can cause more leverage is hired by the company, not for utilizing benefits offered by employing debt, but because of negligence to be cautious of the risk embedded in debt. In this case, audit committee as part of BOC is not performing well and is not contributing to good corporate governance.

The p-value for audit committee meeting frequency is 0.018 and the Beta value is -0.003. The hypothesis of significant negative relationship between the meeting frequency of audit committee and debt ratio is accepted. The mean of this variable is found to be 10 and according to the works of Abbott et al. (2003), Abbott and Parker (2000), and Persons (2009), how often audit committee conducts meeting shows its diligence. So it seems that the audit committees in public listed companies in Indonesia in this study are active indeed. By then, it can be assumed that they are fulfilling their monitoring duties well. This is then reflected in the capital structure of companies that carries less debt.

One hypothesis regarding the control variable in this research is accepted which is firm size with p-value of 0.000 and Beta value of 0.053. This is consistent with previous studies of Karadeniz et al. (2011), Lim (2012), and Nguyen & Ramachandran (2006). This result is in line with trade-off theory where diversification capability of larger firms helps them to be less prone to going bankrupt. So, as risk is pressed down, the company therefore can afford to obtain higher debt financing. The calculation

of debt ratio in this study is using long-term debt. According to the aforementioned previous studies, bigger companies are expected to take more long-term debts while the smaller companies are expected to focus more on short-term debts. Since the size of the companies in Indonesia is relatively big, therefore the confirmation of hypothesis 8 supports the common view on big companies are usually utilizing long-term debt.

The other independent variables are not found significantly affecting debt ratio. Among the insignificant variables, Big 4 auditors, ownership concentration, and ROE have the sign of their coefficient just as predicted though, meaning they are supporting the view offered in this study but the relationship is not strong enough.

The rejection of hypothesis regarding Big 4 auditors caused by lack of significance may prove what is stated in the works of Siregar & Utama (2008) is true regarding Big 4 auditors is not a good representation of audit quality in Indonesia. The literature found the result for Big 4 auditors in their research was indeed in line with what its authors were expecting but it was insignificant. The result was that Big 4 auditors lowers the effect of future profitability in their research concerning the effect of corporate governance on opportunistic earnings management in Indonesia.

The insignificance of ownership concentration is in line with the finding on debt ratio. The debt ratio of Indonesian public listed companies studied in this research is considered low to mediocre, considering the figure for Malaysian' public companies debt ratio is 44.39% which is more than twice of that of Indonesia. Because the variable ownership concentration is not significant, as a consequence, the debt amount is still relatively small although public companies in Indonesia on average are relatively highly concentrated. Nevertheless, by sign, the outcome of this research is agreed by several other works like that done by Ongore & K'Obonyo (2011), Alba et al. (1998) and Du & Dai (2005), both as cited in Gill et al. (2012), and also the finding of Al-Deehani & Al-Saad (2007), Driffield et al. (2007), and Pindado & De La Torre (2005), all three of them are as cited in Fatma & Chichti (2011).

The insignificant result of the relationship between profitability and debt ratio is also experienced by Nguyen & Ramachandran (2006) in their research. Nonetheless, the sign of the finding is the same with the hypothesis both in this research and in the research by Nguyen & Ramachandran (2012). In contrast, Lim (2012) in his research found that profitability is significantly negatively influencing leverage financing decision. The sign implies that indeed public listed companies in Indonesia is following pecking order theory, that if more profits are generated, companies use them for financing instead of debt. This is in support with the idea of reducing risks that this study is leaning towards.

The justification for the rejection of the hypothesis concerning managerial ownership both by sign and by significance level is provided by Adnan et al. (2011) who discovered contrasting insignificant outcome for insider ownership in relation to risk. Based on their descriptive statistics, there were only 2.22% of shares owned by company insiders. The implication of this was that there might be not enough influence given by the share ownership on managerial decisions. This then made the share ownership by insiders not resulted in reducing risk of the company. Similarly, the descriptive statistics in this study also shows very little number of 0.4182%. Therefore, explanation provided by Adnan et al. (2008) may as well be applicable to this research outcome concerning managerial ownership. Another possible reason for the insignificance of managerial ownership is that in the Indonesian public listed company environment, family ownership may be more relevant than managerial ownership as has been researched by Siregar & Utama (2008). It was proven there that family ownership did do a good job on developing good corporate governance in Indonesian public listed company environment. This further confirms why the figure for managerial ownership in Indonesia is low, that is because mostly Indonesian firms are family firms.

The finding of this research is consistent with the discussion of that of Rakhmayil and Yuce (2009) and what they had been expecting in their research, though not the outcome of their research. They proposed that CEO tenure, as a representation of more qualified executive director, would exploit the benefit of tax advantage that lied in debt in order to maximize firm value. According to the descriptive statistics result for this research, CEOs of Indonesian public listed companies are young in tenure age with a mean of only 5 years and a maximum of 15 years, while the mean of the CEO tenures in the U.S., where the study by Rakhmayil and Yuce (2009) took place, was 11.5 years with a maximum of 44 years. As stated in their work, relatively short tenured CEOs were more aggressive in hiring debt than the longer ones. So, the finding of this study satisfies the reasoning of the hypothesis in Rakhmayil and Yuce's (2009) work.

5. Conclusion

This study researches on the effect of corporate governance on capital structure in public listed companies in Indonesia. The result is some corporate governance variables affect capital structure. The outcome of this study suggests that only BOC element of corporate governance that does matter in its relation to capital structure decision.

BOC is the backbone of corporate governance. Without BOC, there is no party that supervises the work of BOD as top leaders who drive the company. GMS on their own cannot monitor BOD effectively, that is why BOC is created in the first place to represent them. BOC also serves a bridging role between the company and external auditors. This shows that public listed companies in Indonesia have already had the awareness of the importance of BOC in building good corporate governance. Through BOC, these companies have been forming capital structure that is safer for shareholders.

Based on the outcome of this research, BOC seems to be the only corporate governance element matters to influence capital structure in this research. In response to this study, Indonesian public listed companies in general then may want to improve the quality of other factors of corporate governance. This can be done supposedly by having the National Committee for Governance to compose and enforce the practice of more encouraging regulations on other features of corporate governance.

The finding of this research is a reflection of the condition of corporate governance in Indonesian public listed companies and its influence on capital structure. There will always be rooms for improvement in corporate governance. Indonesian companies should keep striving to enhance the quality of their corporate governance because companies with good corporate governance are recognized by shareholders and they appreciate that by giving premium values for these companies (Pae & Choi, 2011). Besides, companies with good corporate governance also become more competitive in the market as they will attract investors (Heng et al., 2012; Pae & Choi, 2011).

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