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The relationship between corporate governance and firm performance: An empirical analysis of Indonesian companies

Husnah[1*], Aryati[2], Ramlawati[2], Mochammad Fahlevi[3]

[1]Department of Management, Faculty of Economics and Business, Tadulako University, Indonesia
[2]Faculty of Economics and Business, Muslim Indonesia University, Indonesia
[3]Management Department, BINUS Online Learning, Bina Nusantara University, Jakarta 11480, Indonesia
Corresponding Author: husnah@privietlab.org

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ABSTRACT

The goal of this study is to investigate the relationship between corporate governance practices, as indicated by the Corporate Governance Perception Index (CGPI) scores, and key performance indicators (ROA, ROE, EPS) of publicly-listed Indonesian firms. Utilizing a panel data set comprising 112 Indonesian firms across various sectors, both fixed and random effects models were employed to discern the effects of corporate governance on firm performance. The dataset spanned five years, resulting in a total of 560 observations. The findings revealed a positive and statistically significant correlation between superior governance practices and enhanced firm performance. Specifically, a one-unit increase in the CGPI Score corresponded with increases in ROA, ROE, and EPS, even after controlling for variables such as firm size and industry type. Corporate governance plays a pivotal role in influencing the financial performance of Indonesian firms. Firms adhering to higher governance standards showcased better performance metrics, underscoring the strategic importance of robust governance mechanisms in the Indonesian business landscape. The results hold significant implications for Indonesian businesses, investors, and policymakers. Effective governance practices not only serve as a beacon for potential investors but also position firms for sustained growth and stakeholder trust in an increasingly competitive and interconnected global economy.

Keywords: Corporate Governance, Firm Performance, Corporate Governance Perception Index (CGPI), Indonesia Companies.

1. INTRODUCTION

The significance of corporate governance in business is a topic of extensive academic discussion and empirical examination. Corporate governance is believed to play a crucial role in influencing firm performance, engendering stakeholders' trust, and ensuring organizational longevity. Research by Arora and Sharma (2016) demonstrated that firms boasting robust governance structures tend to surpass their counterparts, exhibiting weaker governance in terms of various performance metrics. Likewise, Fahlevi et al. (2022) and Panisi et al. (2019) highlighted the positive correlation between transparent governance practices and elevated levels of investor confidence.

However, the multifaceted nature of corporate governance makes its impact on firm performance a complex subject. Ben Bouheni et al. (2016) identified a direct positive correlation between specific governance mechanisms and firms' financial outputs. Conversely, (Pandey et al., 2022) posited that corporate governance positively influences accounting performance but negatively affects market performance, this relationship is intricate and is often modulated by external factors, including prevailing market conditions and geopolitical dynamics.

In light of these findings, the present research aims to further explore the relationship between corporate governance and firm performance in today's business context using a quantitative approach. By comparing and contrasting our results with those of previous studies, we aspire to present a holistic perspective on how contemporary corporate governance practices the trajectory of firms.

2. LITERATURE REVIEW

Corporate governance, at its core, refers to the systems and processes by which companies are directed and controlled (Cadbury, 1992). Governance structures define the distribution

of rights and responsibilities among various stakeholders and set out the rules and procedures for decision-making. Danoshana and Ravivathani (2019) and Yusuf et al. (2023) explored the link between robust governance structures and firm performance. Their study encompassed firms from various countries and found a consistent pattern, companies with stronger governance structures generally showed better financial performance. This was attributed to reduced agency costs, better decision-making processes, and increased trust from stakeholders.

Ab Razak and Palahuddin (2014) extended this by directly tying specific governance mechanisms, such as board structures and audit committees, to firms' financial outcomes. The finding was clear: when these mechanisms were well-established, companies often reported healthier financial metrics. Bathula (2008) pivoted the discussion towards the effects of governance on investor trust, and they argued that transparent governance practices were critical in fostering investor confidence. Their cross-country analysis revealed that transparency in governance often led to increased investment and lower capital costs, given the reduced risks perceived by investors (Fahlevi, Moeljadi, et al., 2022).

It's not all straightforward, however. (Pandey et al., 2022) introduced a layer of complexity by emphasizing the modulation of the governance-performance relationship by external factors. Their research in emerging markets showed that while good governance was generally beneficial, its effects could be overshadowed or amplified by factors like market conditions and geopolitical shifts. As corporate landscapes change, so too does the nature of governance. Recent literature has started addressing the role of digital transformation, stakeholder activism, and environmental concerns in reshaping governance paradigms (Husnah & Fahlevi, 2023). These studies indicate that while the core tenets of governance remain, their applications and implications are continually evolving.

3. RESEARCH DESIGN

This study employs a quantitative correlational design to assess the relationship between corporate governance practices and firm performance among Indonesian companies. Using the Jakarta Stock Exchange (IDX), a sample of 112 publicly-listed companies (2016-2020) will be randomly selected. These companies will span various industries to ensure a comprehensive understanding of corporate governance practices across sectors. Financial data will be extracted from annual reports available on the IDX website and company websites. Information on corporate governance practices will be gathered from the Corporate Governance Perception Index (CGPI) ratings provided by the Indonesian Institute for Corporate Governance (IICG).

The firm performance will be measured using financial indicators such as Return on Assets (ROA), Return on Equity (ROE), and Earnings Per Share (EPS). Corporate governance practices, measured through CGPI scores. These scores encapsulate various governance aspects, including transparency, accountability, responsibility, independence, and fairness.

Firm size (measured by total assets), industry type, and market capitalization, given that these factors might influence firm performance. Given that real-time intervention might be challenging, a Monte Carlo will be utilized to understand the results. By assigning probability distributions to uncertain variables within our corporate governance metrics (for instance, future changes in policies or regulatory landscapes), the Monte Carlo method will generate thousands of possible outcomes, allowing us to understand potential variations and trends better (Saunders et al., 2009; Sekaran & Bougie, 2016). Descriptive statistics will be used to summarize the main features of the collected data (Lind et al., 2018). Multiple regression analysis will be employed to ascertain the relationship between corporate governance practices and firm performance, controlling for the specified control variables. To ensure the reliability of the results, the Cronbach's alpha coefficient will be computed for the CGPI scores. A value above 0.7 will be considered satisfactory. The content and construct validity of the CGPI metrics, as provided by IICG will be examined to ascertain validity.

All data will be collected from public sources, ensuring no breaches of confidentiality. Moreover, any company data used for simulation purposes will be anonymized to maintain the integrity and reputation of the involved firms.

4. RESULT

Sample Distribution

A total of 112 publicly-listed Indonesian companies were selected across various sectors. The panel data spans five years, providing a total of 560 observations.

Table 1. Sample Distribution by Sector

Sector	Number of Companies	Percentage (%)
Energy	22	19.6
Financial	20	17.9
Consumer Goods	18	16.1
Telecommunications	15	13.4
Healthcare	12	10.7
Others	25	22.3
Total	**112**	**100**

Table 2. Descriptive Statistics

Variable	Mean	Median	Std. Deviation
ROA	8.5%	8.2%	3.1%
ROE	15.7%	15.2%	5.2%
EPS	IDR 320	IDR 310	IDR 80
CGPI Score	72.4	72	8.5

Panel Data Analysis

Fixed effects and random effects models were estimated to discern the relationship between corporate governance (measured using CGPI scores) and firm performance (ROA, ROE, EPS).

Table 3. Regression Results

Variable	Fixed Effects (ROA)	Random Effects (ROA)	Fixed Effects (ROA)	Random Effects (ROA)	Fixed Effects (EPS)	Random Effects (EPS)
CGPI Score	0.05*	0.04*	0.08*	0.07*	IDR 2.5*	IDR 2.3*
Firm Size	0.03	0.02	0.05	0.04	IDR 1.5	IDR 1.4
Industry Dummies	Yes	Yes	Yes	Yes	Yes	Yes
R-squared	0.63	0.62	0.58	0.57	0.59	0.58

Note: * indicates significance at the 5% level.

Based on the Hausman test, fixed effects were more appropriate for ROA and ROE, while random effects were more suitable for EPS. The CGPI Score, representing corporate governance practices, demonstrated a positive and significant relationship with all three measures of firm performance. Specifically, a one-unit increase in the CGPI Score was associated with an increase of 0.05 in ROA. An increase of 0.08 in ROE. An increase of IDR 2.5 in EPS.

5. DISCUSSION

The results of our analysis shed light on the significant relationship between corporate governance, as measured by the CGPI Score, and firm performance across several indicators, including ROA, ROE, and EPS. This discussion seeks to interpret these findings, compare them with previous research, and ponder on their broader implications. The positive correlation between the CGPI Score and the three performance indicators underscores the importance of robust corporate governance practices for Indonesian firms. This finding is consistent with prior research by (Ben Bouheni et al., 2016; Danoshana & Ravivathani, 2019), which indicated that strong governance mechanisms often lead to enhanced financial performance. Effective governance structures can bridge the gap between management's interests and those of the shareholders, leading to efficient decision-making (Jensen & Meckling, 1976). Good governance might bolster investor confidence, as highlighted by Juhandi et al. (2020). This could facilitate easier access to capital and better investment terms for companies.
The firm size, though factored into our regression models, displayed a less pronounced effect on performance than the CGPI Score. This suggests that, while larger companies might naturally have access to more resources, good governance is an equalizer, enabling even smaller firms to perform competitively. Though our sample encompassed diverse sectors, we controlled for industry effects in our models. This nuance emphasizes that while certain sectors might naturally yield better financial outcomes due to market demand or regulatory advantages, good governance is universally beneficial.

Based on the Hausman test, the choice between fixed and random effects indicates that while firm-specific time-invariant characteristics play a role in influencing ROA and ROE, EPS is influenced more by random fluctuations over time. This suggests that while long-term performance metrics like ROA and ROE are deeply intertwined with a firm's inherent governance structures, short-term earnings might be more susceptible to market volatility. Indonesia, as an emerging market, is keen on attracting foreign investments. Our findings suggest that firms adhering to higher governance standards stand a better chance in this endeavor. Moreover, given global shifts towards sustainable and responsible business practices, Indonesian firms with better governance might also find themselves better poised to address environmental, social, and governance (ESG) concerns, which are increasingly shaping investment decisions globally. While our research provides valuable insights, it is crucial to acknowledge its limitations. The study relies on CGPI scores, which, though comprehensive, might not capture all nuances of corporate governance. Future research could delve deeper into specific governance mechanisms or investigate the dynamic interplay between governance and other firm-specific characteristics.

6. CONCLUSIONS

Our study rigorously explored the relationship between corporate governance practices and firm performance within the context of Indonesian companies. The findings underscored a positive and statistically significant relationship between enhanced governance mechanisms, as reflected by the CGPI Score, and multiple indicators of firm performance, namely ROA, ROE, and EPS. The empirical evidence from this study resonates with international research that asserts the importance of strong corporate governance as a catalyst for financial prosperity. The consistency of these findings across various industries in our sample further amplifies the universal importance of robust governance structures, regardless of sectoral nuances.

The implications of our study are far-reaching and pivotal for the Indonesian business landscape. Firstly, in terms of business strategy, Indonesian firms must understand that emphasizing corporate governance extends beyond meeting regulatory benchmarks. Effective governance practices can be a strategic cornerstone, promising tangible financial advantages. As Indonesia ardently works to elevate its stature as an enticing hub for investments, those companies that excel in governance standards are poised to reap the most benefits. Their adherence to governance best practices is bound to instill a deeper trust among investors, both local and international, leading to potential advantages in terms of investment conditions and ease of capital acquisition. Additionally, from a regulatory standpoint, it's paramount that those shaping policies recognize the clear correlation between governance and corporate performance. There is an imperative not only to fortify governance stipulations but also to invest in training and resources that can enable businesses to elevate their governance standards. Subsequently, this can catalyze broader economic gains.

The implications of governance are not restricted to shareholders alone. A wide array of stakeholders, encompassing employees, consumers, and the larger community, can find value in firms that prioritize governance. Companies rooted in strong governance principles often manifest greater transparency, adhere to ethical practices, and exhibit a profound sense of social responsibility in their modus operandi. As we gaze into the future of the business world, marked by intricate global linkages and an ever-discerning investor community,

Indonesian corporations championing stellar governance standards are primed to lead the charge, both within the region and on the global stage. Their governance-driven ethos will not only cement their local dominance but also amplify their global outreach and influence.

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