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The Effectivity of Internal and External Corporate Governance Mechanisms Towards Corporate Performance

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Abstract
Corporate Governance is a concept emerging from the agency theory, as to synchronize between the owner and management's interests. The achievement of corporate performance relies on the mechanism efficiency of *Corporate Governance* both internally and externally. This study is intended to show the influence of *Corporate Governance* towards the corporate performance, particularly the profitability and the corporate's dividend policy. The study was conducted to all non-financial corporations in the Indonesian Stock Exchange during 2007 – 2010. The result of the study shows that the *external corporate governance* which was measured through the existence of institutional ownership and debt holder has a higher effectiveness than *internal corporate governance* which was measured by the independent commissioner's ratio towards the corporate performance.
Keywords: *corporate governance*, dividend policy, profitability

1. Background and goals of the study

In an organization, especially a public corporation, functional specialization is required in order to achieve more efficient goals. In *The Modern Corporation and Private Property*, Berle and Means (1932) state that in an organization there should be a separation between the corporate owners and managers, which result in consequences regarding the organizational sociology and economy.
Based on the agency theory introduced by Jensen and Meckling (1976) it is shown that the separation of ownership and control will result in the agency relationship when the principal deputes their authority towards the agent to execute some services of the principals that are conceptualized in a series of contracts. Such separation can lead towards conflicts as a result of the conflict of interests which generally occur in almost all individual activities in the principal – agency hierarchy.
The agency conflicts can be alleviated with contracts, although not all aspects can be stated in such contracts. Thus, *corporate governance* is needed to help the corporate synchronizes the interests of all members of the organization (Hart, 1995). *Corporate governance* is a law system, rules and factors that control the corporate operations (Gillan, 2006).
Corporate governance mechanisms can be divided into the internal and external mechanisms (Gillan, 2006; Rezaee, 2007). The internal mechanism is derived from the board of commissioners, internal control, and internal audit functions. The quality of the internal mechanism is closely related to a better corporate performance (Aman dan Nguyen,2008). Whereas the external mechanism is derived from the capital market, corporate control market, labor market, state status, court decisions, stock holders, and investor activities.
The balance and effectiveness of the *corporate governance* mechanism can create a better corporate financial performance. Dividend, as one of the financial performance measurements is one of the financial management policy to achieve corporate objectives. Dividend policy is related to a corporate option to pay to the stake holders, the amount of the payout and its time frequency (Meggison, 1997). The right decision regarding the dividend is sometimes a hard choice due to the need towards balancing the power of those who potentially can create conflicts.
Factors that determine the dividend payout remain the researches' focus nowadays. The *earning* factor becomes a consideration in the dividend payout (Lintner,1956; Baker and Powell,1999; Kumar,2006). The dividend policy is an interaction of the corporate investment decisions as viewed by Rozeff (1982). In their analysis, Frankfurther and Wood (2002) mention that there are no rational economic reasons that can explain the dividend phenomenon. Black (1996) states that dividend is a dividend puzzle, a paradox that cannot explain the reasons why corporations pay the dividend. However, dividend still becomes an important consideration for the investors when making decisions on investment Chiang et al. (2006), Allen et al. (2000), Guo and Ni (2008).
This study is to analyze the roles of the *corporate governance* mechanisms both internally and externally that influence the corporate finance performance in non finance corporations in Indonesia. In this study, the external

mechanism is measured by the existence of the institutional ownership and by the existence of the debt holders, especially in the banking institutions. The previous study shows a contradictory result about the relationship between the *corporate governance* and the financial performance. Han et al. (1999), Allen et al. (2000), Rubin and Smith (2009), Abdelsalam et al. (2008) who analyzed the influence of *corporate governance* especially through the institutional ownership show a positive correlation between the dividend policy and the institutional investors. On the other side, Grinstein and Michaely (2005), Harada and Nguyen (2006), who conducted their research in Japan found that corporate governance through the ownership concentration has a negative correlation with the dividend policy. The result of this study reveals that *external corporate governance* is more effective and thus has a greater influence than *internal corporate governance*.

2. Corporate Governance

In order to define the corporate objectives, *corporate governance* takes an important roles to enable the manager to manage the corporations and create a good management strategy. According to Hart (1995), the *corporate governance* issue has been rising due to two conditions: the agency problems as a result of the conflicts of interests among the members in the organization and the cost of transactions due to the fact that agency problems cannot be settled by contracts.

Rezaee (2007) states that *corporate governance* is traditionally viewed as a mechanism to synchronize both the management and the stockholders' interests. More specifically, the role of the *corporate governance* is to reduce the agency cost and to create a long term value for the stockholders with the focus on both the board of directors' monitoring responsibility and the senior executives' managerial functions.

Researchers often categorize *corporate governance* mechanisms into two categories, i.e. internal and external corporate mechanisms. The internal mechanism is divided into five basic categories, they are: the board of commissioners (roles, structures and incentives), managerial incentives, capital structure, constitutions and corporate regulations, and internal control system. Whereas external mechanism is divided into five categories, they are: law and regulations, market, capital market information and analysis, accounting market, finance and law, and special sources of external control (Gillan, 2006).

2.1 Independent Commissioners as *internal corporate governance*

Gillian (2006) explains that the mechanism of *internal corporate governance* exists in a corporation, and comes from two parties, they are the board of commissioners as the highest point that conducts the internal controlling system and the management that acts as the corporate agency.

One internal mechanism that can reduce the agency problems is the existence of the independent board of commissioners that can represent the stockholders' interest with the main responsibility to approve the important managerial decisions, including the ones involving the investment policy, management compensation policy and the board governance itself, as well as to monitor the implementation of the decisions that have been taken (Byrd et al.,1998; Bhagat and Bolton, 2008).

In the Indonesia's Code of Good Corporate Governance (2006), it is stated that the independent commissioners are the board of commissioners' members who are not affiliated with the directors, the other members of the board of commissioners and the controlling stockholders, and they have neither business nor family correlations with the controlling stockholders, other members of both the board of directors and board of commissioners as well as with the corporation itself, which may influence their independency and their authority to act solely for the corporation. Therefore, one of the missions of the independent commissioners is to promote the implementation of *Good Corporate Governance* in corporations in Indonesia.

In this study the *internal corporate governance* is measured by the proportion of the independent commissioners from the total members of the corporation's board of commissioners (David et al.,1998; Tihanyi et al.,2003; Aman and Nguyen,2008; Chi and Lee, 2010).

2.2. Institutional ownership as *external corporate governance*

According to Jensen and Meckling (1976) ownership structure is viewed from the agency problem due to the separation of the ownership and control. Ownership structure is not only connected with the agency cost, in this case debts and equity, but also the crucial factor, that is, the equity distribution that refers to votes and capitals, and the identity of equity ownership.

Ownership structure is systematically varied in some ways. Demsetz and Lehn (1985) mention that there are some general power that may influence the ownership structure, they are: the size of the corporation, control potential, regulating systems, potential comfort from corporate outcomes.

Investors are commonly divided into two types: the individual and the institutional investors. Institutional ownership has very important roles in the *corporate governance*, especially in relation to its ability for

monitoring, gaining information and its impacts towards both corporate policies and performance. Some empirical studies that have been conducted in relation to the *monitoring* ability of institutional ownership are Cornett et al. (2007), Guo and Ni (2008), Elyasiani and Jia (2010) who have pointed out that institutional investors may differ form individuals in terms of the stock quantity and their expertise in gaining information and managerial monitoring. The role of the institutional ownership in influencing the strategic corporate policies is analyzed by Denis et al. (1999), Tihanyi et al. (2003) who state that corporate strategic decision diversification is the representation of the corporate decisions where conflicts of interests between the managers and stockholders lie.

The definition of institutional investors in this study refers to David et al. (1998), who mention that institutional ownership is the stock ownership by an organization or institution, not the individual ownership. In this study, the institutional ownership is measured by the percentage of the institutional ownership and institutional ownership consistency. According to Chen et al, (2008) there are three benefits in a massive ownership, i.e. they are correlated with the higher proportion of the economical profit due to cost effectiveness, cost reduction in coordinating the management, and big institutions will find more difficulties and more expensiveness when it try to sell its big quantity of shares.

Ownership consistency shows the ownership stability and the length of investment for an investor. Bushee (1998) mentions that a consistent ownership enables the owner to do the monitoring and to regulate the managers to maximize long term values than short term benefits. Elyasiani and Jia (2010) state that the ownership time span is an important factor in determining the institutional roles. Institutional investors have different investment time span in their portfolio. Investors with longer term of investment show that the ownership stability has more opportunities to examine the corporation as a motivation towards a more effective monitoring, which can reduce asymmetric information and to decrease pressure to the managers, to alter the executive compensation and to adjust with both the management and stockholders' interests.

2.3 The Debt holder as an external corporate governance

Debt holders are the external party who gives loans to corporations and can also function as the corporate governance mechanism. Jensen and Meckling (1976) state that loans cause a bonding mechanism for the managers to bring good outcomes for the stockholders, by not creating an opportunity to deviate from the corporations' free cash flow. The bigger the loans, the more cash the corporations will have to pay for the interest and installment. Loan taking by the managers will cause risks to the corporations if the managers fail to show an effective performance. Thus, the use of loan can change the management's monitoring from the stockholders to the creditors.

According to Jensen (2000), the use of loans as a financial source should go along with the debt covenant as a payout requirement to stimulate the managers' discipline and to limit activities that may destroy the recovery of the loan. John and Senbet (1998) say that a debt contract will make the managers work as being part of the owners by making investment decisions and optimal financing, in order to maximize the corporate value for the owners.

In this study, debt holders will be measured by the debt holder concentration, especially from a banking institution. The existence of debt holders, especially from the banking institution has a specific role, as a delegated monitor for the depositors. Such an institution collects money from the investors, lend and monitor the agent as a part of itself. Debt holders' monitoring and screening activities will give both positive and negative outcomes for the external party, for the other creditors and stockholders (Triantis and Daniels(1995).

3. Corporate Financial Performance

One of the measurements to judge the corporate financial performance is the dividend, that is, the payout that each stockholder receives. Megginson (1977) mentions that the dividend policy decision is a corporate option to pay to the stockholders their payouts as a dividend and to decide the amount to be paid as well as the frequency of it. In order to set a dividend policy, the management will refer to the scheme on the size and the pattern of cash distribution to the stockholders through a period of time (Baker, 2009). The precise decision on the dividend scheme is sometimes a difficult choice because of the needs to balance the many forces potential to conflicts. The management needs to consider a trade off, that is, if a corporation pays dividend to the stockholders, it might reflects the good state of the corporation, while in fact, it reduces other investments. On the other hand, if a corporation reduces the dividend, the company's growth is increasing, however, in a glance it looks as if it decreases the stockholders' prosperity. According to Baker and Powell (1999) this conflict happens because of investments, funding and dividend decisions which are related to each other.

The factors that determines the dividend paid by the corporation is a problem that sometimes attracts attention from the corporations and the researchers. Lintner (1956) is a researcher who conducts a classical study on how the US managers make the decisions about the dividend. Lintner's results of the study concludes that current net earning is the main factor which is generally used as a base for the dividend changes decision, because net earning is always reported periodically and is published in the financial reports. Frankfurther and Wood (2002), Truong and Heaney (2007) are the researchers who support earning as the base for the dividend scheme. In this study corporate performance will be measured by the dividend policy, that is, the dividen payout ratio and profitability (return on equity).

4. Research Methods

The research objects in this study are all non-financial corporations, which have paid dividend in 2007 – 2010. The used financial date is based on both the annual and quarter data gained from www.idx.co.id and from the *Indonesian Capital Market Directory*. The data was taken by means of pooled data under purposive sampling techniques. 128 corporate annual data units were derived using the mentioned criteria.

The internal corporate governance mechanisms is measured by the use of the independent commissioner's proxy ratio, a proportional number of the independent commissioners from the total number of the board of commissioners. The external corporate governance mechanisms is measured by the use of two proxy: institutional ownership consistency and institutional ownership consistency. The earlier is measured by the use of a measurement proposed by Elyasiani and Jia (2010), i.e. institutional ownership persistence (IOP) from the average ratio of proportional ownership divided by the standard deviation of proportional ownership during the period of analysis.

$$IOP_i = \sum_{j=1}^{Ji}\left[\left(\sum_{t=1}^{n} p_{i,t}^{j} /n\right)/Std(p_{i,t}^{j})\right]/Ji$$

t= analysis time, p=institutional investor proportion in a corporation i by investor j at the time t, Std=standard deviation p during analysis period, J=number of institutional investors in corporation t.

The institutional ownership concentration is summed up from the percentage of the five biggest institutional ownerships. Profitability, as a mediation variable, is measured by the means of the dividend payout ratio (Dividend/EAT). Data analysis is measured by the use of path analysis approach with the completion of AMOS 16.0 program.

5. Results and Discussions

Based on the descriptive analysis in Table 1, it is stated that there are non financial corporations that pay the dividend although they have lost (DPR -0.0223, ROE -0.1674) and there are also corporations that pay dividend that is more than the the profit they gain in that year (DPR 1.3633). Such a condition shows that those corporations will use their internal funds to pay for the dividend.

The Independend Commissioners average (RKI) owned by the corporations is 0.3696, which means that the average corporations have the number of independent commissioners in accordance with the rules, that is, minimum 30% of the total number of the commissioners.

Although the corporations' debt holder power (IHU) has varied values from close to 0 up to 1, the debt holder concentration average is 0.4073. This condition shows that corporations tend to avoid borrowing a long term fund from a particular bank and will in turn divide the loans to some banks as to reduce the pressure of debt covenants.

The ownership consistency values (IOP) shows the variations of huge consistency among the sampled corporations. This condition shows that there is an institutional ownership which is very consistent in defending its ownership in the same number and for a long time , however, on the other hand, it also tends to be very inconsistent by changing the ownership.

The Institutional ownership concentration (IOC) shows that the institutional ownership average is concentrated in a quite a high value of 0.653, it even has the maximim value of 0.997. This shows that stock ownership in Indonesia tends to be owned by institutions in great number and only a few are owned by individuals/comunity.

Prior to a further test, with the use of path analysis testing approach – which generally uses Maximum Likelihood estimation – an assumption is tested: data normality and non existence of the outliers data as well as its multicollinearity (Ghozali, 2008). Evaluation of the Data Normality, the testing result shows that the value of CR for multivariate is 5.323, although this figure is above the critical value, i.e. ± 2.58. However, Klein (2005)

figures out that the data will cause problems when the CR value is more than 10. Thus, this can be categorized as a normal data. The Outliers evaluation, shows that the maximum Mahalanobis value is 19.298. This figure is smaller than the chi square value (χ^2) (6;0.001)=22.46. This shows that there are no multivariate outliers. The multicollinearity evaluation, as taken from its sample correlation matrix, shows that there is no single variable tested that has a value of more than 0.90, so the multicollinearity among variables does not occur.

The goodness of fit test to measure whether the observatory input fits the proposed model prediction will be conducted after the assumption testing fulfills the requirements. Two measurements, i.e. absolute fit measure and incremental fit measure are used to conduct the test. Based on Table 2, the models have chi square, probability, GFI, NFI, AGFI and TLI values according to the fit requirements have a proper goodness of fit, so that the hypothesis testing can be conducted.

The hypothesis testing through path analysis show three significant hypothesis results (Table 3). The institutional ownership concentration (KKI) has significant positive impacts towards both profitability and corporate dividend. The significant results in this hypothesis support the agency theory concepts that the interaction between the institutional ownership and financial performance is part of the agency theory mechanism to reduce the agency conflicts (Megginson,1997; Byrd et al.,1998). The existence of the institutional ownership in large amount is assumed to have the monitoring capability, the ability to influence the management, so that the owners' interests and the management's will align (alignment theory); and therefore it will lead to a better organizational performance. This testing result is in accordance with Cornett et al. (2007), Chen et al. (2008), Elyasiani and Jia (2010). The concentration of ownership can also give impact to the management so as not to perform non-profitable activities, such as over-investment and unprofitable investment. In this case, the dividend payment is an option to reduce free cash flow that can be used by the management. Besides, the larger number of votes of the institutions will be more effective for fighting for better dividend payout (Truong and Heaney, 2009; Rubin and Smith, 2009).

The consistency in ownership (IOP) has no significant influence in both corporate performance i.e. ROE and DPR. This insignificant result is estimated that the actual ownership consistency shows the investment purposes of the investors. The consistent and stable institutional ownership tend to have long term goals, which prefers to choose monitoring which offers information advantages. To get long term benefits, the investors will delay the dividend acceptance and support more the corporate investment activities (Renneboog and Trojanowski, 2005; Kumar, 2006).

The existence of the debt holder through its concentration does not have a significant positive influence towards profitability (ROE), towards a negative coefficient. The insignificant results and the direction towards the negative coefficient show that debt holders as an institution that gives loans has a number of mechanisms, especially through debt covenants. Debt covenants can prevent the debt holders from bankruptcy and can give the rules of preference to the managers to act more carefully and to stimulate improvements in managerial activities. For the corporations, although loans can help them to conduct their activities, however, the risks and responsibilities will influence both the corporate performance and outcomes. This makes them tend to use internal funds and lessen the concentration of debt holders by asking for loans to some banks. This hypothesis result does not go along with Triantis and Daniels (1995) who mention that the existence of the debt holders with their debt convenants will be able to increase the borrowers' value through improvements on the managerial slack.

The debt holders' concentration has a significant negative influence with the dividend policy (DPR) on the p value of 0.084. This empirical study is in accordance with the agency theory which shows the existence of conflicts between the debt holders and stockholders. The dividend payout by the stockholders will lessen the corporation's free cash flow. but, this will also decrease the availability of cash for the debt holders to pay installments and interest, and vice versa.

In order to synchronize the interests of both the debt holders and corporations, a debt contract or covenant needs to be made. The more concentrated the debt holders power, by a means of a contract, the debt holders will make an agreement, in its effort to guard his/her rights from the possibility of lost and of corporation's policy one of which is related to the dividend payout. The above argumentation supports the statement which mentions that the debt holder's concentration as an external corporate governance mechanism can use their power to do controlling the corporation, i.e. controlling the use of cash flow. The results of this study goes along with the research conducted by Brockman and Unli (2009) who mention that the creditors' rights will influence the corporate decisions, because the creditors will apply competitive rules with debt holders and stockholders' interests. Creditors' rights alleviation will cause reduction on the numbers of dividends.

The existence of the independent commissioners (RKI) does not have a significant influence towards the corporate performance which is measured through profitability (ROE) as well as the dividend policy (DPR). The

insignificant result shows that internal corporate governance, especially the existence of the independent commissioners does not support the agency theory because of its ineffectiveness in doing the controlling. Such a condition is assumed to be caused by the fact that the nature of the commissioners' independency in Indonesia tends to be contradictory to the requirements for the board of independent commissioners' members. It is assumed that the independent commissioners are not really independent towards the corporations, or, this has become a way for the corporations to introduce the term independency, or they might be the CEOs for the other corporations so that they have limited time and focus. Such an argumentation is in accordance with the one stated by Abdel Salam et al. (2008), Chi and Lee (2010); Yammeesri and Herath (2010) which say that the existence of the independent commissioners is not important in improving the corporate performance.
The corporate profitability (ROE) does not influence the dividend policy and has a negative coefficient. Such an insignificant result is against the net earning approach by Lintner (1956), which means that the dividend payout policy is not determined by the *earning* only. The existence of other corporate policies to utilize profitability for other purposes, such as for corporate investments, Rozeff (1982) states that when the growth of corporation's yield is high, they will decide a low dividend payout because it will be used for the corporate investments. The insignificant result might be because of the world phenomenon about the tendency of corporations for not paying the dividend and pay it with a decreasing margin payout in spite of corporations' good profit (Denis and Osobov,2008). Whereas Al Twaijry (2007) states that profitability does not correlate with the payout ratio, because the dividend policy is determined more by the dividend patterns in the past, at present and future estimation.

6. Conclusions

Studies show that the external corporate governance, especially the concentration of institutional ownership and debt holders are more effective in influencing the corporate financial performance than internal corporate governance. Institutional ownership and debt holders have better capabilities in doing monitoring, giving influence, pressure and a better understanding of the information. The internal corporate governance's is not showing a significant influence towards corporate performance which means that the independent commissioners are not really independent, so that they cannot act to synchronize the principal and management's interests. However, to create a good corporate governance, it is necessary to have a balance between both the internal and external corporate governance mechanisms.

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Notes:

Table 1.Descriptive Statistics

Variabel	N	Minimum	Maximum	Mean	Std. Deviation
DPR	128	-0,0223	1,3633	0,3018	0,2567
ROE	128	-0,1674	0,6247	0,1680	0,1116
RKI	128	0,1429	0,6667	0,3696	0,0775
IHU	128	0,0000	1,0000	0,4073	0,4015
IOP	128	0,1567	90,00E15	60,928E14	20,1168E15
KKI	128	0,1232	0,9977	0,6533	0,1996

Table 2. Goodness of Fit Test Full Model

Goodness of Fit Index	Cut off value	Result	Evaluation
Chi-square (df=2)	< 5,991	0,417	Good
Probability	≥ 0,05	0,812	Good
GFI	≥ 0,90	0,999	Good
NFI	≥ 0,90	0,991	Good
AGFI	≥ 0,90	0,989	Good
TLI	≥ 0,90	1,359	Good

Table 3. Estimation Regression

	Stand. Estimate	S.E.	C.R.	P
ROE <--- KKI	**0,214**	**0,050**	**2,398**	**0,016**
ROE <--- IOP	0,137	0,002	1,555	0,120
ROE <--- IHU	-0,028	0,026	-0,308	0,758
ROE <--- RKI	0,084	0,127	0,953	0,341
DPR <--- IOP	0,036	0,004	0,412	0,680
DPR <--- IHU	**-0,156**	**0,058**	**-1,728**	**0,084**
DPR <--- ROE	**-0,217**	**0,199**	**-2,510**	**0,012**
DPR <--- KKI	**0,233**	**0,114**	**2,624**	**0,009**
DPR <--- RKI	0,075	0,285	0,872	0,383

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