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The Impact of Corporate Governance Implementation and Debt Financing on Manufacturer's Firm Performance: Evidence from Emerging Country

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ABSTRACT

Purpose – This study aims to examine the influence of corporate governance and debt financing practices on the dynamics of firm performance in the manufacturing sector listed on the Indonesia Stock Exchange (IDX).
Methodology/approach – This quantitative research paper uses secondary data from the financial statements of manufacturing sector firm for 11 years, between 2009 and 2019. The number of samples that met the established criteria was 190 firm, which were further analyzed using panel regression analysis.
Findings – This study concludes that the application of corporate governance in the manufacturing sector, has both a consistently positive effect on ROA and ROE. Meanwhile, debt financing is based on the analysis of total debt ratio, long debt ratio, and short debt ratio in accordance with profitability and trade off theory.
Novelty/value – This study aims to provide a more general and robust conclusion regarding the effect of implementing corporate governance mechanisms and debt financing decisions on firm performance in emerging country, especially in the manufacturing sector by using periods, samples, variables and analyzing debt ratios with various time periods.

Keywords: Corporate Governance, Debt Financing, Firm Performance

INTRODUCTION

Corporate governance and capital structure decisions play an important role in influencing the firm's financial performance. Corporate governance is generally defined as a system, where firm are directed and controlled (Danoshana and Ravivathani, 2013). Lukviarman (2016) stated that corporate governance is a system that controls and directs firm with the aim of achieving a balance

between power and authority to ensure the continuity of its existence and accountability to shareholders. We use the characteristics of the board of commissioners, which are the board size of commissioners and the proportion of independent commissioners as a measure of corporate governance. According to Fama and Jensen (1983) the board of commissioners is the highest internal control mechanism responsible for overseeing the actions of top management. The proportion of independent commissioners has an important role in monitoring the running of the firm, directing strategies, and ensuring that firm managers are seriously improving the firm's performance as part of achieving firm goals.

Corporate governance as measured by the board size of commissioners (Agustiningsih et al., 2016; Danoshana and Ravivathani, 2013; Utama and Utama, 2019) and the proportion of independent commissioners (Agustiningsih et al., 2016; Putra, 2015) has a significant positive effect on the firm's financial performance. The same result is shown by Handriani and Robiyanto (2019) where the large board size of commissioners will be better able to carry out duties, obligations, and responsibilities in accordance with the provisions so that it has a positive effect on financial performance. On the other hand, Christensen et al (2010) found that the board size of commissioners and the proportion of independent commissioners negatively affect the financial performance of the firm.

Capital structure is a combination of debt and equity that a firm uses to finance their business operations. If this structure is well organized, then the cost of capital decreases which can increase the value of the firm (Aziz and Abbas, 2019). The capital structure is the most important managerial decision because it affects shareholder risks and returns (Pandey, 2010). The capital structure of an enterprise relates to the mixture of debt and equity that the firm uses in its operations. We use three debt ratio indicators to see the capital structure, which are total debt to total assets, long debt to total assets, and short debt to total assets. Enekwe and Nnagbogu (2014) stated that leverage is a financial management policy to obtain funds. Firm that meets funding using debt will provide benefits and losses that will have an impact on the use of debt itself. Thus, leverage can have a different impact on the firm. If the profit generated by the firm can cover fixed costs, then high leverage will certainly be profitable. Conversely, if the profit generated is lower than fixed costs, then leverage will bring losses to the firm and cause the firm's financial performance to decline which results in the firm falling into an unhealthy condition until bankruptcy occurs.

Some studies have tested the effect of leverage on a firm's financial performance (Abor, 2007; Dawar, 2014; Doan, 2020; Sheikh and Wang, 2013; Utama and Utama, 2019). Research conducted by Sheikh and Wang (2013) suggests that leverage measured using total debt ratio, long term debt ratio, and short-term debt ratio negatively affects return on asset. The results of Abor (2007) concluded that total debt ratio, long-term debt ratio, and short-term debt ratio negatively affect the firm's performance. However, the results of research by Abor (2005) stated that total debt and short-term debt ratio had a significant positive effect on the firm's financial performance. This suggests that firm rely more on debt as a primary funding option and are using more short-term debt to finance their operations. However, empirical findings remain unclear whether debt is good or bad. Empirical arguments and findings go both ways. Some researchers argue that debt has a positive effect on financial performance, while other researchers oppose such claims with the reason that debt has a negative effect on financial performance.

Several studies have been conducted to examine the effect of corporate governance and debt financing on firm performance, but the results have not been consistent, depending on the specific conditions of each firm and the period used. Therefore, this study aims to provide a more general

and robust conclusion regarding the effect of implementing corporate governance mechanisms and debt financing decisions on firm performance on emerging country, especially in the manufacturing sector by using periods, samples, and research variables that are more detailed, long, short, and complete term, and also a robustness test is carried out in order to obtain more accurate and reliable results so as to enrich the literature review related to the implementation of corporate governance and debt financing on firm performance.

LITERATURE REVIEW

Agency Theory

Agency theory is two interconnected parties between the principal (shareholder) and the agent (manager). According to Jensen and Meckling (1976) stated that the agency relationship is a contract between the manager (agent) and the investor (principal). In the practice of managing the firm, there are conflicts, which is agency problems that occur due to differences in goals and interests between principals and agents, as well as the emergence of costs that are not a few incurred by the firm to monitor agents. Thus, the implementation of the monitoring mechanism is expected to be able to minimize the potential for agents to carry out moral hazard and adverse selection which causes a decrease in performance and business continuity.

The control mechanisms with monitoring are the implementation of corporate governance with the establishment of an independent board of commissioners aimed at making the firm better and healthier. The placement of an independent board of commissioners that dominates the board of commissioners will make the monitoring mechanism very effective so that this practice of corporate governance is stronger (Weisbach, 1988; Agustiningsih et al., 2016).

Fama and Jensen (1983) stated that the board of commissioners is the highest internal control mechanism responsible for overseeing the actions of top management. The board of commissioners consists of unaffiliated parties and affiliated parties. The board size of commissioners is the number of members of the board of commissioners in the firm. The proportion of independent commissioners consists of a board of commissioners who come from outside the firm or are not affiliated with any party, especially the main shareholder, members of the board of directors or other members of the board of commissioners (Handriani and Robiyanto, 2019; KNKG, 2006; Utama and Utama, 2019).

Profitability Theory

Profit is a financial benefit that is realized from business activities when the income generated exceeds the costs incurred in the operating activities of the enterprise. There are various profit theories in economics, Sanyal (2019) groups the theory of profit into five, frictional theory of profits, monopoly theory of profits, innovations theory of profits, risk and uncertainty theory of profits and managerial efficiency theory of profits. Managerial efficiency theory of profit explains that firm that able to manage their policies and resources efficiently and consistently over time will create higher profits so that they can survive in business competition (Bolarinwa et al., 2021; Salvatore, 2019; Sanyal, 2019; Soesetio et al., 2022). The firm's ability to manage and develop its assets and capital determines the profitability will be formed whether it is of positive or negative value. In addition to the firm's ability to manage operations, strategic time and external factors can also provide more benefits even though competing firm have the same resources and information (Makadok, 2011).

Trade off Theory

External debt financing plays an important role in increasing the firm's productivity in the future and more important for future growth (Gomis and Khatiwada, 2016). External debt financing is used when internal sources are not enough to meet the needs of the organization and require more finances and borrowing from outside the organization (Mwangi et al., 2014). Trade off theory is referred to as debt exchange theory which states that firm exchange tax benefits from debt funding

with problems caused by potential bankruptcy (Brigham and Houston, 2011). The fact that interest paid as a tax deduction burden makes debts cheaper than ordinary or preferred shares, or in other words debt provides tax protection benefits (debt tax shields). Myers (2001) argued that firm will owe up to a certain level of debt for tax savings. Debt financing is one of the financial management policies to obtain funds from external (Enekwe & Nnagbogu, 2014). A firm can get investment funds through equity and debt. Firm that finance using debt will provide benefits and losses that will have an impact on the use of debt itself. That way, debt can have a different impact on the firm. If the profit generated by the firm can cover fixed costs, then high debt will be profitable. Conversely, if the profit generated is lower than fixed costs, then debt will bring losses to the firm and cause the firm's performance to decline which results in the firm falling into an unhealthy condition until bankruptcy occurs.

Using 66 selected companies from non-financial companies listed on the Nigerian Stock Exchange between 1999 and 2007, Akinlo and Asaolu (2012) found that debt ratio was negatively correlated with ROA. Chechet and Olayiwola (2014) selected 70 companies among the 240 companies listed on the Nigerian Stock Exchange in the period 2000-2009 and concluded that the ratio of debt to total assets was inversely correlated with the performance of the firm. Another study by González (2013) reported the negative impact of debt ratio to firm performance. In Malaysia, Hamid et al. (2015) examined data on 49 family and non-family companies during the period 2009 to 2011 using three indicators of debt ratios, which are short-term, long-term, and total debt in examining their impact on performance. Their findings reveal the inverse effect of total debt to total assets, long-term debt to total assets and short-term debt to total assets on the firm's performance. Meanwhile, Hutchinson (1995) argues that in more general terms, debt financing has a positive effect on a firm's return on equity provided that the profit strength of the firm's assets exceeds the average interest cost of the debt to the firm.

Following Chang et al. (2019) we use the ratio of total debt to total assets, long-term debt to total assets and short-term debt to total assets as a measures of debt financing. Short-term debt is less expensive than long-term debt but is riskier because they need to be renewed periodically (Rai & Danilevskaia, 2005). A firm may find itself in a crisis if they are unable to renew their debt and will experience a short-term debt cycle. The short-term debt cycle is a condition where there is a buildup of short-term debt that causes profits to decrease because they must pay previous debt (Kurniawan, 2019).

METHOD

The research population is all manufacturing firm listed on the IDX in, 2009-2019 as many as, 197 firm. Sampling technique using purposive sampling method, the criteria is all the data needed is available, so as many as, 190 firm are obtained as an analysis unit. This quantitative research paper uses secondary data from the financial statements of manufacturing sector firm. Measurements of each variable are detailed presented in the table 1:

The use of ROA and ROE as a measure of firm performance are for robustness tests. The use of three measures of debt as an effort to look at each debt ratio in the short-term, long-term, and total debt to financial performance. Common effect model (CEM) panel regression analysis is used as an analytical tool to answer hypotheses that have first passed all classical assumption tests. The regression model used:

$$ROA = \alpha + \beta_1 BSIZE + \beta_2 IND + \beta_3 GROWTH + \beta_4 TANG + \beta_5 TDEBT + e \quad (1)$$

$ROA = \alpha + \beta_1 BSIZE + \beta_2 IND + \beta_3 GROWTH + \beta_4 TANG + \beta_6 LDEBT + e$ (2)

$ROA = \alpha + \beta_1 BSIZE + \beta_2 IND + \beta_3 GROWTH + \beta_4 TANG + \beta_7 SDEBT + e$ (3)

$ROE = \alpha + \beta_1 BSIZE + \beta_2 IND + \beta_3 GROWTH + \beta_4 TANG + \beta_5 TDEBT + e$ (4)

$ROE = \alpha + \beta_1 BSIZE + \beta_2 IND + \beta_3 GROWTH + \beta_4 TANG + \beta_6 LDEBT + e$ (5)

$ROE = \alpha + \beta_1 BSIZE + \beta_2 IND + \beta_3 GROWTH + \beta_4 TANG + \beta_7 SDEBT + e$ (6)

Table 1: Variable Measurement

Variables	Description	Measurement	Source
Return on Asset (ROA)	Measure a bank's ability to make profit from each asset	Earning After Tax / Total Asset	(Octavio and Soesetio, 2019; Utama and Utama, 2019)
Return on Equity (ROE)	Measure a bank's ability to make profit from each equity	Earnings After Tax / Equity	(Hasan et al., 2020; Komara et al., 2016; Soesetio et al. 2022; Sugiarto and Lestari, 2017)
Board Size (BSIZE)	Measure a total board of commisioner	∑ board of commisioners	(Agustiningsih et al., 2016; Handriani and Robiyanto, 2019)
Independent Commisioner (IND)	Measure the percentage of the number of independent board members of the total number of boards of commissioner's members	Independent commisioners / ∑ board of commisioners	(Christensen et al., 2010; Handriani and Robiyanto, 2019)
Total Debt Ratio (TDEBT)	Measure how much assets are funded from total debt	Total debt / total asset	(Chang et al., 2019; Handriani and Robiyanto, 2019)
Long Debt Ratio (LDEBT)	Measure how much assets are funded from long debt	Long debt / total asset	(Chang et al., 2019; Handriani and Robiyanto, 2019)
Short Debt Ratio (SDEBT)	Measure how much assets are funded from current liabilities / short debt	Current liabilities / total asset	(Chang et al., 2019; Handriani and Robiyanto, 2019)
Firm Growth (GROWTH)	Measure how much total assets are used for capital expenditures	Capital expenditures / total asset	(Sheikh and Wang, 2013)
Asset Tangibility (TANG)	Measure the percentage of tangible assets of the total assets	Tangible asset / total asset	(Sheikh and Wang, 2013)

Source: Processed Data, 2022

RESULT AND DISCUSSION

Based on table 2, the average ROA with a value of 0.047 can be explained that the profit generated is 0.047 from every 1 firm asset. The average board size of commissioners with a score of 4. The trend of the average board size of commissioners per year in 2009-2019 has decreased. The average proportion of independent commissioners with a value of 0.367 has an average trend to increase each year from 2009-2019. The average firm growth with a value of 0.040. This shows that the capital expenditures made for investments are not used effectively.

Table 2: Statistic Descriptive

Variable	Obs	Mean	Std. dev.	Min	Max
ROA	1,570	0.047	0.124	-2.641	0.921
ROE	1,570	-0.010	3.547	-136.436	24.731
BSIZE	1,570	4.113	1.774	1.000	13.000
IND	1,570	0.367	0.136	0.000	1.000
GROWTH	1,570	0.040	0.184	-5.499	0.803
TANG	1,570	0.388	0.199	0.001	0.984
TDEBT	1,570	0.551	0.480	0.004	5.073
LDEBT	1,570	0.192	0.297	0.000	3.575
SDEBT	1,570	0.359	0.370	0.001	4.801

Source: Processed Data, 2022

The average tangibility of assets with a value of 0.388. This shows that the firm has tangible fixed assets that are dominant or large. The average total debt ratio with a value of 0.551 means that total assets are funded by 55.1% of debt. The average long-term debt ratio with a value of 0.192 means that total assets are funded by 19.2% of long-term debt. The average short term debt ratio with a value of 0.361. This shows that total assets are funded by 36.1% of short-term debt.

Table 3: Regression Result

VARIABLES	ROA	ROA	ROA	ROE	ROE	ROE
BSIZE	0.004***	0.004***	0.004***	0.012***	0.012***	0.011***
	(0.001)	(0.001)	(0.001)	(0.002)	(0.002)	(0.002)
IND	0.012	0.027**	0.003	0.314***	0.306***	0.231***
	(0.011)	(0.011)	(0.011)	(0.051)	(0.049)	(0.040)
GROWTH	0.077***	0.088***	0.083***	0.155***	0.166***	0.153***
	(0.011)	(0.011)	(0.011)	(0.040)	(0.038)	(0.040)
TANG	-0.096***	-0.086***	-0.116***	-0.234***	-0.231***	-0.265***
	(0.007)	(0.007)	(0.007)	(0.025)	(0.026)	(0.027)
TDEBT	-0.074***			-0.082***		
	(0.006)			(0.010)		
LDEBT		-0.061***			-0.057***	
		(0.007)			(0.013)	
SDEBT			-0.076***			-0.124***
			(0.010)			(0.023)
Constant	0.090***	0.050***	0.089***	0.031	0.006	0.080***
	(0.006)	(0.006)	(0.007)	(0.025)	(0.024)	(0.021)
R-squared	0.330	0.209	0.277	0.175	0.148	0.160

Source: Processed Data. *, **, *** Significant at 10%, 5%, 1%

Effect of Board Size of Commissioners on Firm Financial Performance

Based on the results of the analysis, board size of commissioners has a positive effect on the firm's financial performance proxied with ROA and ROE. This suggests that the larger the size of the board provides greater and deeper knowledge, better quality of strategic decision-making, better monitoring, and performs a role in better policing. A larger board size also means an increase in human resources, with better specific knowledge of the business (Arosa et al., 2013). These results

support previous research conducted by Danoshana and Ravivathani (2013); Utama and Utama (2019) which concluded that the board size of commissioners has a positive influence on the firm's performance. In addition, Agustiningsih et al. (2016) also proved that corporate governance as measured by variables board size of commissioners has a significant positive effect on the firm's financial performance. The same result is shown by Handriani and Robiyanto (2019) where the large board size of commissioners will be better able to carry out duties, obligations, and responsibilities in accordance with the provisions so that it has a positive effect on the firm's financial performance.

Effect of Proportion of Independent Commissioners on Firm Financial Performance

The results of the analysis show that the proportion of independent commissioners has a positive effect on the firm's financial performance using ROE. The more the number of independent commisioners, the better the performance of the firm. The function of the independent board of commissioners is the supervisory board, so when the proportion of the independent board of commissioners is high, the supervisory function will be stricter on management, so that management will always act in the interests of shareholders. When the proportion for an independent board of commissioners is increased, it will increase the firm's performance (Putra, 2015). Jensen and Meckling (1976) explained that the more monitors the better because the occurrence of conflicts is getting lower and ultimately lowering agency costs. This result supports Putra (2015) which proves the positive and significant influence of the proportion of independent commissioners on the firm's performance.

Effect of Debt Financing on Firm Financial Performance

The results prove that total debt ratio, long debt ratio, and short debt ratio negatively affect the financial performance of firm that are proxied by ROA and ROE. This shows that the higher the debt, the higher the default on debt obligations which is also followed by low profits, which has a negative impact on the firm's financial performance. The greater the risks faced by the firm, the uncertainty of making a profit in the future will also increase and it will be difficult to pay off its debt. Among the three debt ratios, short-term debt is the riskiest external debt financing, it can be seen from the coefficient of short-term debt is largest between long-term debt and total debt ratio. Short-term debt is less expensive than long-term debt but is riskier because they need to be renewed periodically (Rai & Danilevskaia, 2005). A firm may find itself in a crisis if they are unable to renew their debt and will experience a short-term debt cycle. The short-term debt cycle is a condition where there is a buildup of short-term debt that causes profits to decrease because they have to pay previous debt (Kurniawan, 2019). This research is supported by the research of Abor (2007); Dawar (2014); Doan (2020); Sheikh and Wang (2013) who found that debt ratio negatively affects the performance of the firm.

Effect of Firm Growth on Firm Financial Performance

Firm Growth has a positive effect on the firm's financial performance proxied by ROA and ROE. The questions taken by the firm's management provide clues for investors regarding how management perceives the firm's prospects. The higher the growth rate of the firm, the higher the level of investment so that firm that have a high opportunity for growth in general, the firm certainly has good firm financial performance. From an investor's point of view, growth in the firm is a sign that the firm has a profitable aspect and investors also expect a rate of return from the investments they make, indicating that the firm has developed well because it has been considered capable of obtaining better profits from year to year. These results also support previous research from Sheikh and Wang (2013); Lin and Chang (2011); Abor (2005) who found that firm growth had a positive effect on the firm's financial performance.

Effect of Tangibility of Asset on Firm Financial Performance

Tangibility of assets negatively affects the financial performance of firm that are proxied by ROA and ROE. Afirm with large, fixed assets shows that the firm also has a large asset depreciation burden as well. So, this will have an impact on reducing the amount of firm revenue. Large or high fixed assets compared to total assets lead to low financial performance of the firm. If a firm has a lot of fixed assets, it cannot guarantee the income that will be generated by the firm, resulting in the firm's financial performance declining and there is no maximum return on assets within the firm. The results of this study are supported by the research of Sheikh and Wang (2013); Zeitun and Tian (2007) which shows that Tangibility negatively affects the firm's financial performance. So that the higher the tangibility, the more the firm's financial performance decreases.

CONCLUSION

This paper used panel regression analysis to examine the effect of corporate governance and debt financing on the performance of firm in emerging countries. In this paper, corporate governance is measured by two indicators, board size of commissioners and the proportion of independent commissioners. The results revealed that corporate governance has a positive influence on the firm's performance. This result explains that the more the number of boards of commissioners, the better the firm's performance. On the other hand, debt financing, which is measured by three debt ratio indicators, which are total debt to total assets (TDEBT), long-term debt to total assets (LDEBT) and short-term debt to total assets (SDEBT) has a negative influence on the firm's performance. Therefore, increased use of debt will decrease profitability. In other words, the higher the debt ratio, the lower the profit the firm can get. The firm growth control variable has a positive effect on the firm's performance, while asset tangibility has a negative influence on the firm's performance.

This result provides an overview for the firm to always pay attention to the number of commissioners, especially the existence and characteristics of an independent board of commissioners and short-term debt management because it is the most influential part of the firm's performance in the manufacturing sector. The addition of variables characteristic of the board of directors as well as gender diversity can be a development for further research.

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