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THE INFLUENCE OF INTERNAL AND EXTERNAL CORPORATE GOVERNANCE MECHANISMS TOWARDS AGENCY COST IN INDONESIA

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ABSTRACT

This study aims to analyse the influence of internal and external corporate governance mechanisms towards agency cost in Indonesia by analysing the managerial ownership, board of commissioners, managerial compensation, auditor size, audit fees and agency cost.

The population in this study consist of all banking industry in Indonesia for the period 2017 to 2019. Sample determined with purposive sampling method. The data is obtained from Indonesia Stock Exchange (IDX). The analysis technique used in this research is multiple linear regression using SPSS Statistics 26.

The results of the analysis show that simultaneously, the five independent variables which include managerial ownership, board of commissioners, managerial compensation, auditor size, audit fees are significantly influence to agency cost. Partially, managerial compensation and auditor size have negative significant effect on agency cost, while managerial ownership, board of commissioners, and audit fees did not influence agency cost.

Keywords: Agency Cost, Corporate Governance.

INTRODUCTION

Agency relationship are arranged when the principal hire another person or organization which is agent performing a services in the name of principal and authorize the agent to make the best decision for the principal. In this situation, it is very important if both parties have the same goal to maximize the value of the company. However, there will be a conflict when both parties prioritize their own interests, there is a trust issue that the agent will not always act in the principal's interests (Michael C. Jensen, 1976).

Conflict will always happen in agency relationship, whereby both the principal and agent have different perspective and concerns on their risk and profit. The person that invest their capital and take risks for the benefits of economic returns, which are principals and agents who managed by industry to avoid risk and concerned about taking advantage of their individual profits (Panda & Leepsa, 2017). But, based on the contract, all of the agency decisions should be made for the sake of principal interests.

One of the example that the company in Indonesia has agency cost and agency problem is PT. Hanson International Tbk. It is a property company that already stated bankrupt. In the inspection that conducted by Financial Services Authority (OJK), there is manipulation was found in the financial statements related to the sale of ready-to-build lots (kasiba) which make the company's revenue raised sharply. This scandal can happen because of lack of protection by shareholders and there is no transparency in financial reporting, which can occur an asymmetry information between the principal and the agent.

So there is a party that can embezzle funds that have been invested by shareholders. This scandal is proving that there is agency problem where the principal and agent does not have the same interest and the agent is prioritized their self-interest so they did manipulation.

The corporate governance is a mechanism that regulates a management in the company to produce a long term sustainable economic value for both of the stakeholders & shareholders. It is a whole process, policies, rules that influence the control of a company. Through corporate governance, it can bring the agent and principle into the same interest (Schäuble, 2019). The presence of corporate governance is expected to be solved agency problem when there is a different ownership between agent and principal. Those differences may lead to agency problem between both parties. If the company has a good corporate governance, then it can be said that the company also applying corporate governance principles which are the accountability and transparency. In this situation, the corporate governance can be the main factors that liable when the crisis to worsen (Mazlina Mustapha & Ayoib Che Ahmad, 2011).

Corporate governance is one of the important factors which may drive the amount of agency cost either internal and external. In internal, managerial ownership can reduce the amount of agency cost. For example, the higher ownership of shares owned by management will make agency costs lower. Ownership of shares by management can help the unification of interests between shareholders and managers so as to reduce agency costs. In external, through auditor size it can reduce agency cost. The larger the auditor size, it can gain public trust by having a good reputation and achievements. So, the company is expecting that will have higher audit quality because the auditor has characteristics that can be associated with quality, such as training and international recognition.

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THEORETICAL FRAMEWORK AND HYPOTHESES DEVELOPMENT

Managerial ownership is the amount of shares owned by a managerial from the total of shares that managed by the company. According to Habib and Jiang (2012), the greater ownership that managers has then the performance by the managers will be better. Through, managerial ownership it will encourage the manager to improve company performance. The greater the proportion of managerial ownership, the manager tend to be strive harder in improving company performance.

Managerial ownership seem able to harmonize the interest between shareholders and management, so it can be assumed agency problems will disappear if a manager is also become an owner (Andrei Shleifer & Vishny, 1997). The greater the managerial ownership, the more productive the manager's actions in maximizing company's performance and resulting in high asset turnover. So, it can reduce the agency cost.

Negative effect means there is a relationship between managerial ownership variable and agency cost variable. The greater the proportion of managerial ownership, the lower the agency cost.

H1: Managerial Ownership has a negative effect on agency cost.

According to Siallagan and Machfoedz (2006), the board of commissioners is responsible for the quality in the presented report. The board of commissioners can improve the quality of earnings by limiting the level of earnings management through monitoring the financial reporting. By monitoring, it can reduce the agency conflict when the agency conflict may create opportunistic management that will reduce the quality earnings.

The presence of the board of commissioners in the company is effective to monitor the manager in accordance with shareholder desires that indicate increasing sales with a marked high asset turnover ratio and will reduce agency cost.

Negative effect means there is relationship between board of commissioner variable and agency cost variable. The higher the number of board of commissioners, it can lower the agency cost.

H2: Board of Commissioners has a negative effect on agency cost.

Everything that is received by manager as return for their work. Basically, compensation will be able to attract and retain employees and improve company performance. Compensation can be used to strengthen the relationships between principal and the agent. The management is responsible to optimize the company profit. This compensation not only motivate manager to work harder but to avoid manager to commit managerial fraud which can make company performance better and increase the asset turnover which lower the agency cost.

Negative effect means there is relationship between managerial compensation variable and agency cost variable. The higher the compensation that received by manager, the lower the agency cost.

H3: Managerial Compensation has a negative effect on agency cost.

Auditor should give a credibility to financial statements and reduce the risk of information that the financial statements are biased, misleading, inaccurate, incomplete and contains material errors according audit standards. When the presence of auditor is function effectively, then controlling the company will be better and agency conflicts can be minimized.

Negative effect means there is relationship between auditor size variable and agency cost variable. The more credibility that auditor has, it will reduce the risk and lower the agency cost

H4: Auditor Size has a negative effect on agency cost.

Basically, a fee that company pays to the auditor as an exchange for performing an audit. With audit fee, it is expected the higher audit fees, it may increase the audit quality and audit effort. Audit fees has some sort of relation with a possibility of arise in agency cost in the company with excess cash flow. Because with high excess cash flow and low growth prospects It will create a possibility that managers will engage in non-value maximizing activities. So, this situation may create a conflict where through excess cash flow and low growth prospects, it is expected to charge higher audit fees to increase the audit efforts and lessen the agency problem (Mishiel, 2015).

Negative effect means there is relationship between audit fees variable and agency cost variable. The higher the audit fees, the lower the agency cost.

H5: Audit Fees has a negative effect on agency cost.

METHODOLOGY

To test the hypothesis in this study, the measurement that are used in the independent variable is asset turnover ratio. According to Wang (2010), turnover has an inverse relationship with agency cost where low turnover indicates managers are not effective in managing assets for optimal investment, then it will be failed in maximizing shareholder profits so that agency cost will increase. A low asset turnover ratio may indicate poor investment decisions, insufficient efforts and an expense in unproductive products (Florackis, 2008). A company with high turnover ratio indicates the more least agency conflicts rather than a company with low turnover ratio, because low ratio could represent the managers are not utilizing the asset to the activities that raise cash flows but using the asset for unproductive purpose (Xu et al., 2017). For the independent variable, there are two out of five independent variables that using dummy variable as the measurement, which are managerial compensation variable and auditor size variable.

The population of this research is all of the banking companies listed on Indonesia Stock Exchange in 2017-2019. Companies that becomes the sample in this study was chosen based on certain criteria with purposive sampling method. The sample criteria are:

1. Banking companies that listed on the IDX during 2017-2019
2. Banking companies that publish their financial statements and annual reports 3 years in a row during 2017-2019 on IDX
3. Companies that issue their financial statements annual reports in rupiah
4. Having the data of managerial ownership, board of commissioners, managerial compensation, auditor size and audit fees.

The data that used in this study are secondary data which taken from sources that are needed in this study. The sources that are obtained in this study are from company's annual report on period of 2017-2019 in Indonesia Stock Exchange (IDX).

Hypothesis testing in this study is using Multiple Regression Analysis. Multiple linear regression is to determine the effect of independent variables which consists of managerial ownership, board of commissioners, managerial compensation, auditor size and audit fees on the dependent variable which is agency cost. The model that are used in testing the hypothesis are The Overall Significance of Sample Regression Test (F Statistical Test), Significant Test of Individual Parameters (t Statistical Test). The F statistical test is showing whether all the independent variables that had entered in the model do have a joint influence on the dependent variable or not. The statistical t test shows how far the influence of independent variable in individually at explaining on the dependent variable. The test aims to determine whether there is a partial influence of managerial ownership, board of commissioners, managerial compensation, auditor size, and audit fees on agency costs in banking companies listed on IDX.

RESULT AND DISCUSSION

The research objects in this research are banking listed companies on the Indonesia Stock Exchange and publishing the financial statement and annual report of the company consistently for 3 years in a row, which is 2017-2019. The population used in this research in total are 44 companies. Through the sampling techniques that have been mentioned in the previous chapter, namely by using purposive sampling. It can be known from all banking listed companies on IDX there were 44 companies that meets the criteria.

Table 1
Research Sampling Criteria

No	Description	Amount
1.	Banking companies that listed on Indonesia Stock Exchange during 2017-2019	**44**
2.	Banking companies that did not published their financial statements and annual report during 2017-2019 in a row	**0**
3.	Banking companies that published their financial statements and annual report in dollar	**0**
	Number of companies that meets the criteria	**44**

Source: Author, 2020.

Table 2
F Statistical Test

ANOVA[a]

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	.024	5	.005	9.912	.000[b]
	Residual	.051	126	.000		
	Total	.075	131			

a. Dependent Variable: AGENCY COST

b. Predictors: (Constant), AUDIT FEES, MANAGERIAL OWNERSHIP, MANAGERIAL COMPENSATION, AUDITOR SIZE, BOARD OF COMMISSIONERS

Source: Author, 2020.

According to the table, the result of significant value is 0.000. since the significant value is 0.000 which is smaller than the significant level of 0.05. It can be concluded that the variables of managerial ownership, board of commissioners, managerial compensation, auditor size, and audit fees had a joint significant effect on agency cost in banking companies listed on the IDX.

The result is all in positive value. Because, the measurement is using asset turnover ratio. This ratio is having an inverse relationship with agency cost. Where, high asset turnover ratio means low in agency cost. So, simultaneously, the relationship between independent variable and the dependent variable is in negative value and the hypothesis is accepted.

Table 3
t Statistical Test

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	.023	.010		2.251	.026
	MANAGERIAL OWNERSHIP	.001	.033	.003	.035	.972
	BOARD OF COMMISSIONERS	.001	.001	.073	.719	.473
	MANAGERIAL COMPENSATION	.025	.004	.459	5.523	.000
	AUDITOR SIZE	.010	.004	.182	2.122	.036
	AUDIT FEES	.000	.001	.012	.115	.909

Source: Author, 2020.

The first hypothesis in this study states that the managerial ownership has a negative effect on agency cost. The regression coefficient of managerial ownership is 0.001 and the significant value is 0.972. Since the significance level ɑ = 5%, then the regression coefficient is not significant because the significance value is 0.972 > 0.05. So, it can be concluded that the managerial ownership did not significantly influence the agency cost. Then, the hypothesis of this study could not be supported.

This can happen because the amount of shares that manager had is unable to harmonize the differences of interests between principal and agent so that agency problems still exist. So, managers will tend to have

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opportunistic behaviour. The authority given by the owner to the manager in managing the company is sometimes misused by managers who act for their own will (individual interests) and not in accordance with the principal's interest which leads to the agency conflict.

The second hypothesis in this study states that the board of commissioners has a negative effect on agency cost. The regression coefficient of board of commissioners is 0.001 and the significant value is 0.47. Since the significance level α = 5%, then the regression coefficient is not significant because the significance value is 0.473 > 0.05. So, it can be concluded that the board of commissioners did not significantly influence the agency cost. Then, the hypothesis of this study could not be supported.

The reason of this influence can happen because of the board of commissioners are unable minimize any mismanagement of corporate governance. So, it cannot prevent agency cost from occurring. There are chances that the size is too large and not good for the company because the decision-making process becomes longer and ineffective. Also, there will be a free rider in the board or the size is too small for the company so the company need more expertise to gain more advice or options to be obtained in the decision-making process.

The third hypothesis in this study states that the managerial compensation has a negative effect on agency cost. The regression coefficient of managerial compensation is 0.025 and the significant value is 0.000. Since the significance level α = 5%, then the regression coefficient is significant because the significance value is 0.000 < 0.05. So, it can be concluded that the managerial compensation has a positive significant influence on agency cost. Then, the hypothesis of this study is supported.

Shareholders as the principal make a contract to ensure their welfare by expecting an increased profitability. The agency problems arise because of the opportunistic behaviour of the agent to maximize its own well-being besides to the principal's interest. In order to prevent the manager's opportunistic behaviour. So, through compensation the managers can be motivated to maximize the company's profit. Then, when managerial compensation is increased so do the asset turnover.

The forth hypothesis in this study states that the auditor size has a negative effect on agency cost. The regression coefficient of auditor size is 0.010 and the significant value is 0.036. Since the significance level α = 5%, then the regression coefficient is significant because the significance value is 0.036 < 0.05. So, it can be concluded that the auditor size has a positive significant influence on agency cost. Then, the hypothesis of this study is supported.

The larger the auditor size is gained public trust by having a good reputation and achievements. So, the company is expecting that will have higher audit quality because the auditor has characteristics that can be associated with quality, such as training and international recognition.

The fifth hypothesis in this study states that the audit fees has a negative effect on agency cost. The regression coefficient of audit fees is 0.000 and the significance value is 0.909. Since the significance level α = 5%, then the regression coefficient is not significant because 0.909 > 0.05. So, it can be concluded that the audit fees did not significantly influence the agency cost. Then, the hypothesis of this study could not be supported.

The amount of the fee that the auditor obtained when completing the audit does not depend on the number of the price that agreed upon by both parties. In order to maintain the credibility and level of trust of an auditor towards of his client, an auditor must act professionally on providing good audit quality to clients. No matter how much the fee is given it does not affect the audit quality. In other words, high audit fees can't guarantee the company to have a lower agency cost.

Based on the explanation above, the simultaneous significance test or F statistical test, it can be seen that the variables of managerial ownership, board of commissioners, managerial compensation, auditor size and audit fees are simultaneously had a significant effect on agency cost. Meanwhile in a partially way, based on the t statistical test it can be seen that the variables of managerial compensation and auditor size have a significant effect on agency cost, while the variables of managerial ownership, board of commissioners, and audit fees did not significant to the agency cost.

CONCLUSION

The results of this analysis and discussion in this study aim to determine the influence of internal and external corporate governance mechanisms towards agency costs in Indonesia. The independent variable in this study is agency cost and it is measured by asset turnover ratio. This ratio has inverse relationship with agency cost. The hypothesis testing in this study is using multiple regression analysis with the method of The Overall Significance of Sample Regression Test (F Statistical Test) and Significant Test of Individual Parameters (t Statistical Test). This study is using banking companies listed on Indonesia Stock Exchange with the period of 2017-2019 as a sample, with a total sample is 44 banking companies. The author using purposive sampling method to select the sample based on the criteria.

Based on the results of the data analysis in the previous explanation, it can be taken as a conclusion. Simultaneously, all independent variables have influence on agency cost according to the result of The Overall Significance of Sample Regression Test (F Statistical Test).

In partially way, based on the result of Significant Test of Individual Parameters (t Statistical Test), the managerial ownership has no significant effect on agency cost. The amount the shares owned by managers will not increase the company's asset turnover and not reduce the agency cost. The board of commissioners has no significant effect on agency cost, the number of members on board of commissioners will not increase asset turnover and not reduce the agency cost. The managerial compensation has a negative significant effect on agency cost, this means that high amount of compensation can increase the asset turnover ratio and reduce the agency cost. Auditor size is also having a negative significant effect on agency cost, this means that large auditor size can increase asset turnover and reduce the agency cost. Audit fee has no significant effect on agency cost, the amount of audit fee will not increase the asset turnover ratio and not reduce the agency cost.

In this study there are several limitations that might affect the results of the study. First, this study uses banking listed company on Indonesia Stock Exchange with a research period of only three years, which is 2017-2019. So, it cannot yet reflect the overall condition of the companies. Second, the results of the coefficient of determination is 28.3%, so there are still 71.7% remaining that influenced by other variables outside this research model.

Based on the limitation above, as for suggestions that can be submitted by the authors according to this study has been done. First, for investors who will conduct transactions on the Indonesia Stock Exchange should pay more attention on managerial compensation and auditor size, because in this study both of these variables have been proven to have a significant influence and able to reduce the occurrence of conflicts and cost incurred. Also, need to pay attention to the application of corporate governance that company have in assessing the characteristics of a company. Second, for managers are advised to be consistent in carrying out a good corporate governance in order to gain shareholders trust that the company's resources are managed appropriately. Third, for further researchers are advised to add research samples with other types of industry and increase the research period so that it is expected to produce better.

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