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The Effect of Corporate Governance and Investment Opportunity Set on Capital Structure, Dividend Policy, and Firm Performance
(A Study on Go-Public Manufacturing Companies in Indonesia Stock Exchange)

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ABSTRACT:

The purpose of this study is to examine and analyze the effect of corporate governance and investment opportunity set on capital structure, dividend policy and firm performance in manufacturing companies listed in Indonesia Stock Exchange. The sample of this research is 38 companies listed in Indonesia Stock Exchange during the five-year observation period from 2009 to 2013. The technique of data collection is using historical data in financial reports officially publicized on the website of Indonesia Stock Exchange. The data are analyzed using descriptive statistical analysis and Generalized Structural Component Analysis(GSCA). The result of the research shows that corporate governance has a significant effect to capital structure, but does not affect dividend policy and firm performance significantly. Investment opportunity set reciprocally has a significant effect on capital structure with a negative direction. Investment opportunity set reciprocally has a significant effect on dividend policy, and investment opportunity set affects firm performance significantly. Capital structure does not have a significant effect on dividend policy reciprocally. Capital structure and dividend policy have a significant effect on firm performance.

Keywords: *Corporate Governance, Investment Opportunity Set, Capital Structure, Dividend Policy and Firm Performance*

1. INTRODUCTION

Organization for Economic Cooperation and Development (OECD) as one of the pioneer international organizations in the development of *corporate governance* principles puts the interests of shareholders as the primary importance for the development of a company, because shareholders can only oversee the business that is usually represented by the board of Commissioners. For majority or minority shareholders, the fundamental interests other than benefit are equal treatment and protection from the company. Protection and equality is especially needed by minority shareholders, given the fact that the minority shareholders are often in a weak position, and therefore need to be protected. (Beasley 1996), states that companies with *good corporate governance* will have a more effective *monitoring* mechanism which will make the company's operation more efficient, thereby increasing firm performance. Fama and Jensen (1983) state that agency problem can be controlled by paying dividends to shareholders. Easterbrook (1984) supports this view by showing that dividend payment can control agency problems by facilitating capital market in monitoring the activities and performance of a company. The effectiveness of *good corporate governance* implementation which is thought to affect capital structure and dividend policy and be able to improve firm performance cannot be separated from financial decision-making by company management which covers three areas, namely investment decision, capital structure decision and dividend decision.

Investment decision is an important factor in company's financial function. Fama (1978) states that firm performance is determined by investment decision. It can be interpreted that investment decision is important because in order to achieve the company's goal, namely to maximize shareholder wealth, will only be generated through company investment activities. Investment opportunity set, capital structure policy and dividend policy of the company are very crucial for improving firm performance. The presence of manufacturing sector in Indonesia is very essential because, first, after a period of decline in performance due to the impact of global economic crisis in 2007-2009, the manufacturing sector is now able to grow and evolve significantly so that Indonesian economy is influenced by the growth of manufacturing sector. Second, the vision of National Industrial development as stated in Presidential Decree Number 28 year 2008 about national industrial policy is Indonesia as a new industrial country in 2020 and strong industrial country by 2025.

2. THEORETICAL OVERVIEW

Corporate Governance

Cadbury Report defines corporate governance as a system that functions to direct and control an organization. Shleifer and Vishny (1977) define corporate governance as a mechanism used to ensure that providers of company funds obtain a refund (return) of the activities undertaken by the manager, or how the providers of company funds have control over the manager. This definition gives more emphasis on the function of corporate governance mechanism in order to conduct supervision and provide security to the shareholders on their investment. Meanwhile, more comprehensive definition coverage is expressed by *Organization for Economic Cooperation and Development* (OECD, 2004) which defines corporate governance as a system of how a company can be directed and supervised. Corporate governance structure divides the rights and the responsibilities of each member participating in a company, such as leaders, managers, shareholders, and other stakeholders through the rules and procedures for decision making related to company activities. By doing all of this through the existing structure, the company objectives can be set and achieved, and supervision of the performance can be performed. Thus, corporate governance is a system of how an organization is managed and controlled. The system of corporate governance, among others regulates the mechanism of decision making at the top level of the organization. Corporate governance regulates the influence of commissioners, directors, and company management to enable checks and balances in the management of the organization. The application of corporate governance makes important decisions in the company no longer determined by a single dominant party, but after getting input and considering the interests of stakeholders. Corporate governance supports more democratic management of the organization because it involves the participation of various interests. It is more accountable because there is a system which will require accountability for every action, and is more transparent. Thus, corporate governance contains two main aspects of balance, namely: (1) internal balance, which manages the influence among the company organs (General Meeting of Shareholders, Commissioners, and Directors),especially matters related to the institutional structure and operational mechanism, (2) external balance, which stresses that company as a business institution in the midst of society should also pay attention to the influence of the company and all stakeholders as the embodiment of the fulfillment of corporate responsibility. Companies should create a balance between the interests of shareholders to make profit and various benefits for other stakeholders, so that in the long term the implementation of corporation does not create conflicts of interest.

Investment Opportunity Set

Investment Opportunity Set was first proposed by Miller and Modigliani in 1961. Miller and Modigliani (1961) state that the value of a company in the eyes of investors relies on:

(1) Normal rate of return that is obtained when investing in capital markets;
(2) The strength to generate profit from physical assets held by the company;
(3) Company opportunity to invest in real assets, such as *goodwill,* which will provide a greater return on investment than the rate of return on investment in the capital market.

Investment opportunity set plays an important role in the theory of corporate finance because the combined assets of the company (assets in place) with investment opportunity will affect capital structure, dividend policy and firm performance (Myers, 1977; Smith and Watts, 1992). A company will not grow or have a growing stock just because it has assets and profits which increase over time. It is because the essence of growth is not expansion, but the opportunity for the company to invest a substantial amount of funds with a greater rate of return than the normal rate of return in the capital market. According to Myers and Majluf (1984), investment opportunity set can be understood as a theory of signaling management to outside parties (signaling theory). Investment opportunity set, based on various theoretical and empirical articles, can generally be defined as company growth prospect in the future from the point of view of investors and other external parties.

Capital Structure

Capital structure is a combination of debt, preferred stock, and common stock planned by the company to increase capital (Brigham and Houston, 2004). The presence of debt as a component in company's capital structure is a tool that can reduce agency conflicts that arise from the tendency of managers to make contradictory decisions with what is desired by shareholders through engagement costs (the component of agency cost). Debts can improve firm performance by forcing managers to be more focused and discipline on the use of funds so that later they can reduce the tendency to use inefficient shareholder's funds. Debts can be an effective substitute for dividends, because managers have their promise to issue cash flows in the future in a way that can not be fulfilled by the modest dividend increase. The management can improve firm performance by determining the right ratio between debt and equity (Ross et al.,2005).Capital structure policy involves balancing (trade-off) between risk and the level of return. Utilizing more debts means increasing the risk borne by the shareholders while at the same time increasing the expected rate of return. Companies often use less debt than what is determined by an optimal capital structure to ensure that they can raise capital from debt if required later (Brigham and Houston, 2004).

Dividend Policy

Decision about how much profit share to be distributed as dividend and how much to be held as retained earning is called dividend policy (Brigham and Gapenski, 1996).If the company chooses to distribute most of its profits as dividends, it will reduce retained earnings and subsequently reduce internal source of funds or internal financing whose cost is the most inexpensive. Conversely, if the company chooses to hold most of its profits as retained earnings, the ability to form internal funds will be greater. Retained earning is one of the most important sources of funds to finance the company's growth. Every company always wants growth and the ability to pay dividends to shareholders, but these two objectives are mutually contradictory. One of the most important functions of financial manager is to set the allocation of profit for dividend payments on the one hand and to restrain profits as retained earning on the other, where both decisions have an effect on firm performance.

Firm performance

Performance also has the meaning result of work or work achievement. However, performance has a broader meaning, not only result of work, but including how the work progresses (Winarno, 2003).This study uses two approaches in measuring firm performance (Hult et al., 2008), namely accounting approach (Financial Performance) and market approach (Firm Value).

Financial Performance

Financial performance is something produced by a company in a given period with reference to the determined standard. *Financial performance* should be something that can be measured and can describe the *empirical* condition of a company of any agreed size (Zarkasyi, 2008). The definition of *Financial Performance* is an analysis conducted to see the extent to which a company has carried out and used financial performance rules properly and acceptably, such as by making a financial report that has met the standard and the provision of SAK (Financial Accounting Standard) or *GAAP (General Accepted Accounting Principle),* and others (Fahmi, 2011).

Firm Value

Firm Valu*e* according to Wikipedia is an economic measure that reflects the market value of the entire business. This is the number of claims of all holders of securities, debt holders, holders of preferred shares, minority interest, common shareholders, and others. Firm value is one of the basic metrics used in business valuation, financial modeling, accounting and portfolio analysis. Meanwhile, according to Brealey et al., (2011), Firm value is equal to the present value of a company or in other words it is equal to the sum of valuesof separate asset. Further, Ross et al., (2008) states that firm value is equal to market value of debt and equity, deduced by cash and what is equivalent to cash held by the company

3. Hypothesis

The composition of research hypothesis refers to the description of introduction and theoretical overview, and 9 (nine) research hypotheses are composed as follows:

H_1:*Corporate governance*(X1) has a significant effect on capital structure (Y1)
H_2:*Corporate governance*(X1) has a significant effect on dividend policy(Y2)
H_3:*Corporate governance*(X1) has a significant effect on firm performance (Y3)
H_4: Investment opportunity set (X2) reciprocally has a significant effect on Capital Structure (Y1)
H_5:Investment Opportunity Set (X2) reciprocally has a significant effect on Dividend Policy (Y2)
H_6:Investment Opportunity Set (X2) has a significant effect on FirmPerformance(Y3)
H_7: Capital structure (Y1) reciprocally has a significant effect on dividend policy(Y2)
H_8:Capital structure (Y1) has a significant effect on firm performance (Y3)
H_9: Dividend policy (Y2) has a significant effect on firm Performance (Y3)

4. RESEARCH METHODOLOGY

The population of this study is manufacturing companies listed in Indonesia Stock Exchange (BEI) from 2009 to 2013 period as many as 136 manufacturing companies, so the unit of analysis in this study is manufacturing companies. The total sample is 37 manufacturing companies for 5 years, that is 185 pooling data with purposive sampling method*,* namely establishment of sample of the population based on certain criteria.

Research Instruments

The data used in this research are secondary data with the data source originating from a) Indonesian Capital Market Directory(ICMD);b) Indonesian Stock Exchange (IDX)statistic*;* c) the financial statements contained in the annual report of manufacturing companies listed in Indonesian Stock Exchange (BEI) in the period 2009 to 2013.Based on the dimensions of time and time sequence, this study is cross - sectional and time series or panel data. The data are obtained using the technique of collecting data from www.idx.co.id.In this study there are five variables being studied, namely corporate governance, investment opportunity set, capital structure, dividend policy, and firm performance which are divided into two exogenous variables and three endogenous variables

5. ANALYSIS AND DISCUSSION

GSCA Analysis

Based on the output of GSCA program analysis obtained from GSCA software, the results for FIT and Afit values are shown in Tabel 1.

Table 1. Identification Goodness of Fit

FitModel	
FIT	0.433
AFIT	0.427

Measure of FIT Structural Model

The analysis result provides FIT value 0.433, meaning that the diversity or phenomenon on the model can be described by the variables that are used (43.3%), while the remainder 56.7% is explained by variables that are not included in the model.

AFIT (Adjusted FIT) is similar to the R square adjusting the regression analysis. AFIT can be used for model comparison. Considering the variables that affect firm performance are not only one, it would be better if the interpretation of the accuracy of the model is using adjusted FIT or AFIT.AFIT model with the greatest value can be selected among better models. The diversity that can be explained by the model is 42.7%, and the rest 57.3% can be explained by variables that are not included in the model.

Estimation Identification and P Value of Each Path Coefficient

The results of identification of path coefficient of each variable and the model that has been described previously can be seen in Table 2.

Table 2. Estimation Result and *P* value of path coefficient

Path Coefficients					
	Estimate	SE	CR	P	DESCRIPTION
X1 -> Y1	0.781	0.394	1.98 *	0.049	SIGNIFICANT
X1 -> Y2	0.030	0.142	0.21	0.834	NOT SIGNIFICANT
X1 -> Y3	0.134	0.123	1.1	0.273	NOT SIGNIFICANT
X2 -> Y1	0.760	0.061	12.42 *	0.000	SIGNIFICANT
Y1 -> X2	0.597	0.056	10.7 *	0.000	SIGNIFICANT
X2 -> Y2	0.615	0.128	4.8 *	0.000	SIGNIFICANT
Y2 -> X2	0.351	0.077	4.57 *	0.000	SIGNIFICANT
X2 -> Y3	0.966	0.119	8.09 *	0.000	SIGNIFICANT
Y1 -> Y2	-0.158	0.112	1.42	0.157	NOT SIGNIFICANT
Y2 -> Y1	-0.110	0.085	1.3	0.195	NOT SIGNIFICANT
Y1 -> Y3	0.280	0.080	3.49 *	0.001	SIGNIFICANT
Y2 -> Y3	0.207	0.097	2.13 *	0.035	SIGNIFICANT

CR* = significant at .05 level

Resultof Hypothesis Testing

The result of hypothesis testing of each path in this study can be seem in the following figure.

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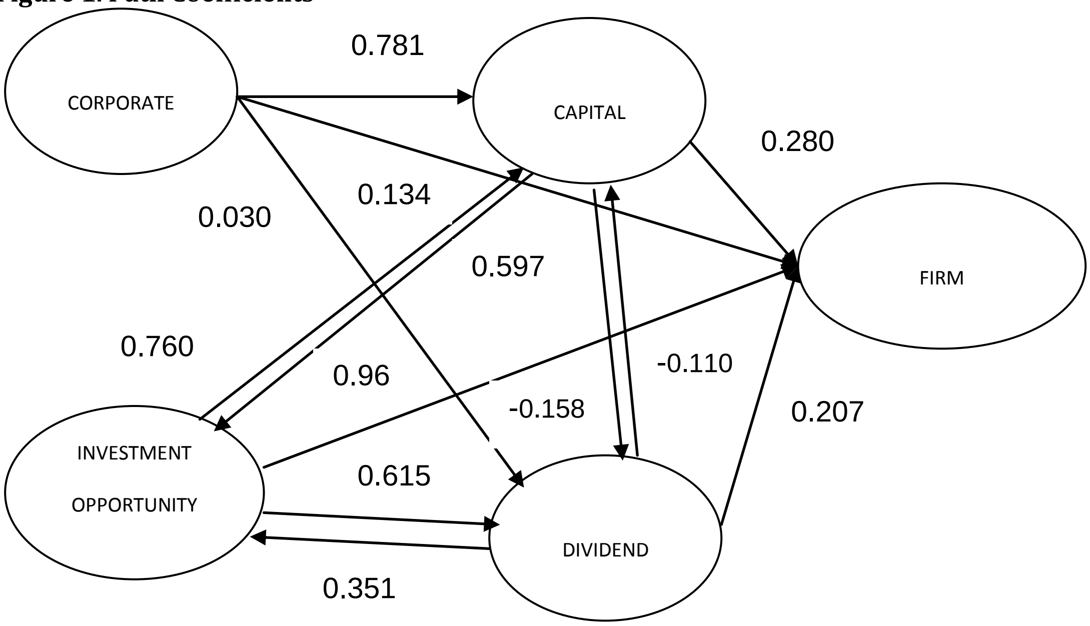
Figure 1. Path Coefficients



H_1:Corporate governance(X1) has a significant effect on capital structure (Y1)

From the analysis result, an estimate value 0.781 is obtained, SE0.394, and CR value 1.98*, and *P* value 0.049with significant level of 0.05, so hypothesis 1 which states that corporate governance affects capital structure is accepted. The direction of the effect is positive, so it can be said that any change incorporate governance gives an effect on the change of capital structure.

H_2:Corporate governance(X1) has a significant effect on dividend policy (Y2)

From the analysis result, an estimate value 0.030 is obtained, SE 0.143, CR value 0.21 and *P* value 0.834 with a significant level of 0.05, so hypothesis 2 which states that corporate governance has a significant effect on dividend policy is rejected. The direction of the effect is positive, so it can be said that any change incorporate governance does not give any effect on the change of dividend policy.

H_3:Corporate governance(X1) has a significant effect on firm performance(Y3)

From the analysis result, an estimate value 0.134 is obtained, SE 0.123, CR value 1.10 and *P* value 0.273 with a significant level of 0.05, so hypothesis 3 which states that corporate governance has a significant effect on firm performance is rejected. The direction of the effect is positive, so it can be said that any change incorporate governance does not give any effect on the change of firm performance.

H_4: Investment opportunity Set (X2) reciprocally has a significant effect on Capital Structure (Y1)

From the analysis result, an estimate value 0.760 is obtained, SE 0.061, CR value 12.42* and *P* value 0.000 with a significant level of 0.05 for the effect of investment opportunity set (X2) on capital structure (Y1). Meanwhile, the estimate value 0.597 is obtained, SE 0.058, CR value 10.70 * and *P* value 0.000 with a significant level of 0.05 for the effect of capital structure (Y1) on investment opportunity set (X2), so hypothesis 4 stating that investment opportunity set reciprocally has a significant effect on capital structure can be accepted. The direction of the effect is positive, which means that the increase of investment opportunity set will be able to increase capital structure, and the increase in the capital structure will be able to improve investment opportunity set.

H_5:Investment Opportunity Set (X2) reciprocally has a significant effect on dividend policy (Y2)

From the analysis result, an estimate value 0.615 is obtained, SE 0.128, CR value 4.8* and *P* value 0.000 with a significant level of 0.05 for the effect of investment opportunity set (X2) on dividend policy(Y2),while the estimate value of 0.351, SE 0.077, CR 4.57* and *P* value 0.000 are obtained with a significant level of 0.05 for the effect of dividend policy (Y2) on investment opportunity set (X2). Hypothesis 5 which states that investment opportunity set reciprocally has a significant effect on dividend policy is accepted. The direction of the effect is positive, which means that the increase of investment opportunity set will be able to increase dividend policy, and the increase in the dividend policy will be able to improve investment opportunity set.

H_6:Investment Opportunity Set (X2) has a significant effect On Firm performance (Y3)

From the analysis result, an estimate value 0.966 is obtained, SE 0.119, CR value 8.09* and *P* value 0.000 with a significant level of 0.05, so hypothesis 6 stating that investment opportunity set has a significant effect on firm performance is accepted. The direction of the effect is positive, which means that the increase of the investment opportunity set will be able to improve firm performance.

H_7:Capital structure (Y1)reciprocally has a significant effect on dividend policy(Y2)

From the analysis result, an estimate value -1.58is obtained, SE 0.112, CR value 1.42 and *P* value 0.157 with a significant level of 0.05 for the effect of capital structure (Y1) on dividend policy (Y2), while the estimate value -0.110, SE 0.085, CR value 1.3 and *P* value 0.195are obtained with a significant level of 0.05 for the effect of dividend policy (Y2) on capital structure (Y1).Hypothesis 7 that states capital structure reciprocally has a significant effect on dividend policy is rejected. The direction does not give any effect on the change of dividend policy, likewise any change in dividend policy does not give any effect on the change of capital structure.

H_8:Capital structure (Y1) has a significant effect on firm performance (Y3)

From the analysis result, the estimate value 0.280 is obtained, SE 0.080, CR value 3.49* and *P* value 0.001 with a significant level of 0.05, so Hypothesis 8 which states capital structure has a significant effect on firm performance is accepted. The direction of the effect is positive, which means that the increase in capital structure will be able to improve firm performance.

H_9:Dividend policy (Y2) has a significant effect on firm performance (Y3)

From the analysis result the estimate value 0.207 is obtained, SE 0.097, CR value 2.13* and *P* value 0.035 with a significant level of 0.05, so hypothesis 9 which states dividend policy has a significant influence on firm performance accepted. The direction of the effect is positive, which means that the increase in the dividend policy will be able to improve firm performance.

6. CONCLUSION AND DISCUSSION

Conclusion

Based on the result of inferential analysis that has been done, the answer to the problems and objectives that have been established in this research can be concluded as follows.

1. Corporate governance has a significant effect on capital structure. The result of this research supports Jensen and Meckling's theory of agency concluded by Al-Najjar and Taylor(2008),which state the higher the level of share ownership by managers, the lower the agency problem in the company. The trick is by regulating the balance of interest between corporate managers and share holders. As a result, the role of debt as the controller of corporate manager's actions is replaced with increased share ownership by corporate managers.
2. Corporate governance does not have a significant effect on dividend policy. It is because based on the research result, the average of institutional ownership (KI) is 72%, and it includes concentration of ownership, so it allows affiliation among the owner, supervisor, and director of the company.
3. Corporate governance does not have a significant effect on firm performance. It is because many firms implement corporate governance only due to regulation. The research result suggests that 92.10% company of the total sample has an independent commissioner with tenure more than one period and 7.90% company has an independent commissioner with one period of tenure, so that the independence of the independent commissioner is doubted. In addition, the independent audit committee with tenure more than one period is amounted to 81.58% company of the total sample, so the independence of the audit committee is doubted.
4. Investment opportunity set reciprocally has a significant effect on capital structure with positive direction of influence. This result apparently supports the Pecking Order theory proposed by Myers and Majluf (1984). This theory states that companies with a high level of profitability have a low level of debt, because companies with high profitability have abundant internal source of fund. This result also supports the over-investment problem which states that leverage is a mechanism to address over-investment problem, thereby causing a negative influence between leverage and investment.

5. Investment opportunity set reciprocally has a significant effect on dividend policy with positive influence. This result is consistent with the theories: a).Free Cash Flow which states that companies having investment opportunity set but have little free cash flow will pay lower dividend, b). Signaling theory, namely considering the condition of the company based on the perspective of people outside the company. Signals from the company will be analyzed further by analysts before making a decision. c). Dividend irrelevance theory reveals that investment decision is first-order value decision, and dividend decision is a second-order value decision because dividend decision is made after investment decision has been set.
6. Investment opportunity set has a significant effect on firm performance with positive direction of influence. This result is consistent with a).Agency Theory which states that in companies there should be separation between owner as the principal and management as the agent. Management goal is to maximize shareholder value which can be fulfilled by the realization of investment opportunity set into real growth (Ehie and Olibe, 2010). b). Signaling Theory stating that high investment opportunity set will give a positive signal to the market, which in turn can improve firm performance.
7. Capital structure reciprocally does not have a significant effect on dividend policy with negative direction of influence. It is because reciprocally changes in capital structure are not unidirectional or not linear with changes in dividend policy.
8. Capital structure has a significant effect on firm performance with positive direction of the influence. This result is consistent with a). Agency Theory stating that management objective is to maximize shareholder value, one of them through capital structure. Masulis (1980) shows that changes in capital structure affect firm performance, b). Optimal Capital Structure Theory which explains that the right combination between debt and equity will result in an optimal capital structure that will improve firm performance (Modigliani and Miller, 1958; Miller and Modigliani, 1963; Myers, 1977).
9. Dividend policy has a significant influence on firm performance with positive direction of influence. The result of this study indicates that most investors prefer certain dividends at present time rather than uncertain capital gains in the future. This result is consistent with a). Agency Theory stating that management objective is to maximize shareholder value. One proof that management maximizes the value of the company is the ability and willingness to pay dividends to shareholders (Stevens and Jose, 1992). b). Bird-in-the-hand Theory which states that investors feel safe to earn revenue in the form of dividend payment rather than to wait for capital gain (Gordon, 1959; Gordon, 1963; and Lintner, 1962; in Lintner 1963).

Suggestions

Suggestions for Manufacturing Companies

1. In implementing corporate governance, companies not only should meet regulatory or government regulation, but must implement it according to the rules. For example, Act No.40 year 2005 about limited company article 120 verse 2 explains that independent commissioner is appointed by decision of Annual General Meeting of Shareholders (AGM) of the parties not affiliated with major shareholders, directors and/or members of other commissioners. Thus, the independence of independent commissioners will be realized in the implementation of their role.

2.Companies should be able to make corporate governance as a corporate culture so that the application of corporate governance principles not only meet regulations, but can also improve overall firm performance.

Suggestions for Government

Government should carry out more intensive monitoring and control to the manufacturing companies in implementing corporate governance, and there should be sanctions for those that do not comply.

Suggestions for Investors

Investors should be more conservative (careful) in making investment by conducting observations to see the seriousness of the company in implementing *corporate* governance, so investments are made in companies corresponding with their expectations.

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Appendix 1. Variables and Indicators

Variables	Indicators	Notation	Explanation
Exogenous Variables			
Corporate Governance (X 1)	Board of Independent Commissioner (DKI)	$X_{1.1}$	The proportion of the members of board of commissioners who comes from outside the company (independent) to the overall number of the members of board of commissioners
	Audit Committee (KA)	$X_{1.2}$	The proportion of independent commissioners in audit committee with the total members of audit committee.
	Managerial ownership (KM)	$X_{1.3}$	It constitutes theproportion of ownership by the management of the company with the number of shares outstanding
	Institutional Ownership (KI)	$X_{1.4}$	A proportion of share ownership by either government or private institutions with the number of shares outstanding
Investment Opportunity Set (X 2)	*Book to Market Value of Assets* (MBE).	$X_{2.1}$	Reflecting the growth of company's book value.
	Ratio of Depreciation to Firm Value (DEP).	$X_{2.2}$	Reflecting the reduction *of assets in place*
	Ratio of capital expenditure to book value of assets (CAPBVA)	$X_{2.3}$	Showing the flow of additional capital of a company based on book value of assets.
	Ratio of capital expenditure to market value of assets (CAPMVA)	$X_{2.4}$	Showing the flow of additional capital of a company based on market value of assets
Endogenous variables	Indicator	Notation	Explanation
Capital structure	Total Debt / Total Equity (NBUE)	$Y_{1.1}$	Showing the effect between the number of loans granted by the creditors with the amount of capital provided by the owner of the company.
	Total Debt / Total Market Value of Equity (NPUE)	$Y_{1.2}$	Showing the effect between the number of loans granted by the creditor with the market value of equity

	Total Debt / Total Assets *(LEVERAGE)*	$Y_{1.3}$	Reflecting how much company assets are financed by creditors
Dividend Policy	Dividend per Share (DPS)	$Y_{2.1}$	Reflecting the amount of profits earned by each share
	Dividend payout ratio (DPR)	$Y_{2.2}$	Reflecting the amount of net profits distributed to shareholders.
	Dividend yield (DYIELD)	$Y_{2.3}$	Reflecting dividend payment done by the company every year
Firm Performance	*Price earning ratio (PER)*	$Y_{3.1}$	Showing the comparison between market price per share to earnings per share
	Tobin's Q	$Y_{3.2}$	Showing the comparison between the market value of *equity* to book value of *equity.*
	Return On Investment (ROI)	$Y_{3.3}$	As a measurement of performance, used to evaluate the efficiency of an investment or to compare the efficiency of a number of different investments