Corporate Governance and Agency Cost: Case in Indonesia

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Abstract—The objective of this study is to investigate the impact size of board commissioners and proportion of independent commissioners (corporate governance) to agency cost. Board commissioners are board in the company monitoring and controlling board of directors. Agency cost is proxied by expense ratio. Sample in this study is manufacturing companies listed in the Indonesian Stock Exchange from 2008 until 2010 which meets the sample criteria. The results of this research show that alternative hypotheses are supported. The results show when the numbers of board commissioners and proportion of independent commissioners increase, agency cost will decrease. The results support the regulation in Indonesia that suggest that all public companies and state companies must hire independent commissioners. The commissioners have responsibility to protect the interest of non-controlling shareholders or minority shareholders.

Keywords—Agency Cost, Board Commissioner Size, Corporate Governance, and Independent Commissioner.

I. INTRODUCTION

The objective of this paper is to improve [1]. They find that there is abnormal return surrounding independent commissioner appointment announcement. It indicates that the market reacts to the announcement in the Indonesian Stock Exchange. Therefore, this study investigates whether board commissioners including independent commissioners can mitigate agency cost. The Indonesian Stock Exchange had released Kep-315/BEJ/06200 and Kep-339/BEJ/07-2001 suggesting all public companies must hire independent commissioner and audit committee. The Indonesian Capital Market Supervisory Agency also had released the Regulation Number III.A.3 suggesting the authority and empowerment of board of commissioners in public companies. Based on the announcement from the Indonesian Stock Exchange on February 18, 2002 Peng-797/BEJ-PEM/02-2002, there are 272 companies (86%) hiring independent commissioners. Only 240 companies qualify and 32 companies are unqualified. There are 40 companies have not appointed independent commissioners yet [2].

The next regulation is Government Act No.40 of 2007 about Incorporated Company. In the regulation, board of commissioners are the parts of company who has generally responsibility to oversight and monitor in accordance with the budget and also give advice to board of directors. Act in article 120 and 1st paragraph requires the public companies to have one (or more) independent commissioners and one deputy commissioner on their board commissioner. Based on the Regulation of Registration No.1A of General Provisions Securities Registration, the requirement for minimum number of independent commissioners are 30% (at least) from total number of commissioners. Independent commissioners are appointed by the General Meeting of Shareholder and taken from parties which are not affiliated with controlling shareholder, members of board directors, and the other members of board commissioner (article 120, 2nd paragraphs). The existence of board commissioners also has an important role to provide reliable financial statements.

While the board of commissioner monitoring and providing reliable financial statement, board of director had also another function in the company. Based on Act no.40 of 2007, board of directors is part of company with authority and responsibility to manage the company in order to meet the company interests. Both of those boards, board of commissioners and board of directors, have under the supervision of shareholders. The shareholders give an authority for board of commissioners to monitor the board of directors. The shareholders also give authority for the board of directors to manage the whole company. This relation between shareholders and director s are called by agency relationship. Agency relationship is a contract which one or more persons (the principal) engage another person (the agent) to perform some service on their behalf which involves delegating some decision making authority to the agent [3]. In the relationship between shareholders and board of directors, shareholders are as the principal and board of directors is the agent. According to [3], there is a good reason to believe that the agent will not always act in the best interests of the principal regarding both parties are utility maximizes. This condition occurred in the relationship between board directors and shareholders. It is generally impossible for the principal (shareholders) or the agent (board of directors) at zero cost to ensure that the agent (board of directors) will make optimal decisions from the principal’s point of view.

In agency relationships there will be some divergence between the agent’s decisions and the optimal decisions that should maximize the principal welfare. According to [3], the number of reduction in the principle welfare as the result of those divergences is also a cost of the agency relationship.
This cost refers as the residual loss. The residual loss is as an agency cost [3]. The problems of divergence decision may occur in the relationship between shareholders and board of directors. Therefore agency cost can not be avoided. To minimize the bad activities from board of directors there are some alternatives can be done by shareholders such as increase the number of insider ownership, increase dividend payout ratio, and institutional investor as the monitoring agent [4]. Here, the existence of board commissioners (independent and deputy commissioners) should have an effect on the agency cost regarding their role as monitoring agents in the company. Board of commissioners has an important role to provide a reliable financial statement. The existence of board commissioners affect the quality of financial reporting and are used as measurement of the fraudulence level of management [5].

Prior empirical research and various recommendations in [5] suggest that there are some board characteristics that give an impact to the quality of financial reports. Four board characteristics are examined by [5] such as size, independence, motivation, and competence. Those characteristics can affect the effectiveness of boards. The results show that more effective of boards can improve the quality of financial reporting. The effectiveness of boards as a corporate governance mechanism depends on its size and composition [6]. Large boards are usually more powerful than small boards and considered necessary for organizational effectiveness. Large powerful boards help in strengthening the link between corporations [7]. But, other studies such as [8], [9], and [10] suggest that large boards make less coordination, communication and decision making than small boards.

Another study such as [11] suggests that the small boards significantly affect the efficiency of asset utilization but they do not significantly reduce agency cost. Therefore size of boards does not affect agency cost. According to [6], the composition of non-executive directors (independent directors) can reduce the managerial discretion by exploiting their monitoring and protecting their reputations as effective and independent decision makers. There are positive relationships between the percentage of non-executive directors (independent director) on board and corporate performance [12] and [13]. Therefore, it is meaning that composition of independent in the board will influence significantly to the corporate performance by reducing agency cost. The studies by [14] and [15] have opposite results. They argue that non-executive directors (independent directors) are usually characterized by lack of information about the firm. They also argue that directors do not bring the requisite skills to the job and prefer to play a less confrontational role rather than more critical monitoring one. The composition of board with non-executive director affects company’s performance and increase the agency cost.

From the previous researches, there are some disagreement between one and another. The differences result of previous studies are the motivation of this study to give empirical evidence that the effect of board commissioner size and its independence composition can reduce the agency cost in the Indonesian manufacturing firms within 3 years period.

II. THEORETICAL BACKGROUND AND HYPOTHESIS DEVELOPMENT

A. Agency Cost

Regarding some problem that occurs due to the agency relationship, it is generally impossible for the principal or the agent at zero cost to ensure that the agent will make optimal decisions from the principal’s viewpoint [3]. Different interest between agent (board director) and principal (shareholder) will rise from the divergence between director’s decisions and shareholder’s decisions which would maximize the welfare of shareholders. The number of reduction in shareholder’s welfare as the result of the divergence include as cost of the agency relationship. This cost is as the residual loss [3]. Moreover, [3] defines agency cost as the sum of (1) the monitoring expenditures by the principal, (2) the bonding expenditures by the agent, and (3) residual loss. Monitoring expenditure refers to cost incurred by principal to reduce divergence activity of agent. Bonding expenditure interpreted as contract cost for agent. Residual loss is the number of reduction in principal’s welfare as the result of divergence between agent’s and principal decision. According to [16], agency cost is cost that incurred by shareholders to push the board directors to work which is maximizing stock price instead of work as their own interest.

Following [17] and [18], this study uses proxy to measure agency costs. The first proxy is a direct agency cost which is calculated as the difference in expense between firm with a certain ownership and management structure. This measure captures excessive expenses including perk consumption. To facilitate the cross-sectional comparisons, this study standardizes the calculation to operating expenses scaled by annual sales or called as expense ratio.

B. Board of Commissioners

In general definition on the scope of duties, authority and responsibilities of commissioner have been set forth in the Act No.40 of 2007 about incorporated company. Based on that government Act No.40 of 2007 about Incorporated Company, board of commissioners are the parts of company who are in charged to generally and/ or particularly monitoring in accordance with the budget and also give advice to the board of directors. The Act requires company to have one or more independent commissioners and one deputy commissioner. There are two common functions of board commissioners, including members of the independent commissioner as (1) overseeing the directors of the company in achieving its goals in the business plan and provide advice to the board of directors regarding business management deviations that do not fit with the direction addressed by the company, (2) Monitoring the implementation and effectiveness of good corporate governance. To make sure that the functions and duties of board commissioners running well, it is necessary to ensure that all policies and decisions issued by the board of
commissioners doesn’t stand for board of director interest as the "agent" or a bias to the "owner's interest." Here the independent commissioners have a role to represent the interests of minority shareholders.

Following principles are needed to be filled to ensure that commissioner’s work is effective such as (1) board commissioners’ composition should allow the decision making to be effective, precise and fast, and independent, (2) Board members have to be professional, integrity and capability to perform their functions properly, including ensuring that board of director has been considered to all stakeholders’ interest, and (3) board commissioners have monitoring and advisory functions including the action to prevent, improve, and suspend.

C. Independent Commissioners

The terms and existence of independent commissioners emerged after the publication of press release from the Indonesian Capital Market Supervisory Agency: SE03/PM/2000 and Indonesia Stock Exchange No. 339/BEJ/07-2001, July 21, 2001. Under the regulation, the public companies must have members of the board of commissioners who are independent. According the Act No.40 of 2007 (Article 120, 2nd) independent commissioners are outsiders who are not affiliated with the controlling shareholder or major shareholder, board director, or other member in the board commissioners. The criteria for independent commissioners have been set on Indonesian Capital Market Supervisory Agency’s regulation as (1) outsider of the public company, (2) do not have any shares of the public company, directly or indirectly, (3) not affiliated with the commissioners, directors and major shareholder, and (4) do not have any relationship business with public company either directly or indirectly. The existence of independent commissioners appears to be related to the provisions of the implementation of good corporate governance.

D. Proportion of Independent Commissioners

The composition of board commissioners is an important point to monitor effectively [19]. According to [20], board composition have important role on corporate performance. Board composition refers to the number of commissioner and the type as determined by the usual insider and outsider classification. Insiders are the current members of top management teams and employees of the company or its subsidiaries. Outsider commissioners must not have association affiliated or non-affiliated to the company. Affiliated outsiders are not members of the current management or employees of the company, but they have some influential link with the firm. Non-affiliated outsiders are usually referred to as independent commissioners. These independent commissioners are hired primarily because they have expertise, reputation, recognition and skills [7].

According to [18], the proportion is ratio of number of non-executive boards (independents boards) to total number committee on the boards. Based on The press release from Indonesian Capital Market Supervisory Agency, public company must hire minimum one independent commissioner. The Indonesian Stock Exchange requires at least 30% of the board of commissioners as independent commissioners.

E. Previous Research

According to [19], the board of directors (commissioners) is the highest internal control mechanism for monitoring. They argue that outside boards have incentives to carry out their monitoring tasks and not to collude with top managers to expropriate stockholders’ wealth. The inclusion of outside boards increases the board’s ability to monitor top management effectively in agency problem arising from the separation between corporate ownership and decision control. Non-fraud firms have boards with significantly higher percentages of outside members than fraud firms [21].

Greater agency costs imply a greater need for monitoring by outsider on the board. Therefore, use of outside board is expected to reduce the agency cost [22]. The opposite result, according to [17], agency costs are significantly higher for outsider managers than insider manages. Outsider board has less ability to monitor than insider board [17]. Agency cost will increase if there are many outsiders [17]. These results are supported by other research such as [14] and [15]. Large board is usually more powerful than small board [6]. Hence, it is considered more importance for organizational effectiveness. Large powerful board will help in strengthening the link between corporations [7].

F. Hypothesis Development

In company's corporate governance there are three main pillars which are interconnected, that are shareholders or investors, board of directors, and board of commissioners. Shareholders are the part which has resources but they may not have time, effort, and expertise to manage company. They have to find someone to manage it. Board directors are given mandate to manage the resources owned by shareholders in order to obtain the best results which is to maximize shareholder's wealth. Mandate is set forth in the financial and non-financial goals. It is included on annual work plans and budgets which have been approved in the General Meeting of Shareholders. Board of commissioners is the part which receives the mandate from shareholders to ensure that board directors has managed the company in accordance with the shareholders expectation.

Both board directors and board of commissioners have very different function. Board director has to execute the shareholders command, while the board of commissioner’s role is to monitor works of board directors. Board commissioners are important governance mechanism [23]. According to [6], the effectiveness of the board as a corporate governance mechanism depends on its size and composition. Large board is usually more powerful than small board and the large board is considered more important for organizational effectiveness. Large board will help in strengthening the link between corporations and providing
counsel regarding strategic options for the firm [7]. Hence, based on the description, this study expects that the size of board will influence negatively agency cost. To test the expectation, this study formulates following hypothesis.

\[ H_{a1}: \text{The size of board commissioners negatively affects on the agency costs.} \]

The focus on independence board is grounded by agency theory [19]. The functions of the board are to oversight, control, and monitor the directors. Independent commissioner is the best part in the company to control the operation of the company. Prior research such as [24], [25] and [5] suggest that company with higher proportion of outsider director (commissioners) has lower financial fraudulence. The lower financial fraudulence occurs due to strict monitoring from the outsider commissioners. Therefore, if the outsider commissioners can enhance the monitoring and controlling, they will be able to reduce the agency cost. To test the expectation, this study formulates hypothesis as follow:

\[ H_{a2}: \text{The composition of independent board commissioner negatively affects on the agency cost.} \]

III. RESEARCH METHOD

A. Sample

The sample in this study is manufacturing companies which are listed in the Indonesian Stock Exchange during 2008-2010. Determination of the sample is carried out by using purposive sampling which meets certain criteria. The criteria used in this study are as (1) manufacturing companies that have been listed in Indonesia Stock Exchange and publish their financial statement in 2008, 2009 and 2010, (2) manufacturing companies that use Indonesian Currency (Rp) on their financial statement, and (3) manufacturing companies which have information about independent commissioner’s proportion. Source of data used in this research is secondary data including financial statement and composition of board commissioners. Secondary data was obtained from www.idx.co.id and Galeri Efek Universitas Atma Jaya Yogyakarta.

B. Variables

Independent variable is the size of board commissioner and the proportion of independent commissioners. The size of board commissioners is measured by using the number of commissioner in a company [10]. Proportion of independent commissioners is measured by using percentage of outsider commissioner to the size of overall commissioner in a company. Independent commissioner is member of board commissioners which are not affiliated with management, other board commissioners, and the major shareholder. They also must be independent from business relationship or other relationship which can affect their ability to act independently [26].

Dependent variable of this study is the agency cost. The agency cost is an economic concept relating the costs which is incurred by companies. The costs are associated with problems such as differences in interests between shareholders and management. Following [17] this study use expense ratio to proxy agency cost. Expense ratio is measured by operating expense scaled with annual sales. The figure of this ratio is effectively the firm’s management controls operating costs. Firms with high expense ratios are expected to have high agency costs. This study uses total assets as the control variable. Total asset proxies to firm size. This study used total asset in logarithm as the proxy of firm size.

C. Empirical Model

This study uses multiple regressions to test hypothesis. Refer to (1) is as follow:

\[
\text{Expense Ratio} = \alpha_0 + \alpha_1 \text{Size of Board Commissioners} + \alpha_2 \text{Proportion of Independent Board Commissioners} + \alpha_3 \text{Size} + \epsilon_i \tag{1}
\]

IV. DATA ANALYSIS

A. Sample Selection

The number of observation used in this study is 377 firms year. The companies are in the industrial classification such as basic industry and chemical, miscellaneous industry, and consumer goods. The sample selection process is as shown in Table I.

B. Descriptive Statistics

Descriptive statistic analysis is analysis to describe the general condition of the data. Analysis for descriptive statistic contains some statistic description regarding the data such as total sample, minimum number of the sample, maximum number of the sample, mean, and standard deviation. The outputs for descriptive statistic of this study are shown in Table II.

Table II shows the total observations 377 firms year. For expense ratio, the highest number is 15.46 and the lowest is 0. During the year of observation, the average of expense ratio is 0.2038 with 0.820 for standard deviation. The size of board commissioner is 2 for minimum and 10 for maximum. This number shows that every company has more than 1 commissioner. The average for board size is 4.064 with standard deviation for 1.694. In this study the number of independent commissioner are stated in percentage therefore the minimum number is 0.14 and the maximum is 1. The average for independent commissioner is 0.3934 (39.34 %). It indicates that the many company has fulfilled the regulation to have independent commissioner at least 30 % from the total number of commissioners. For the control variable (total assets in logarithm) the lowest number is 20.62 and the highest number is 32.36. The average for this control variable is 27.419 with standard deviation for 1.626.
TABLE I
THE SELECTION PROCESS OF SAMPLE

<table>
<thead>
<tr>
<th>2008</th>
<th>2009</th>
<th>2010</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>The number of manufacturing companies listed in the Indonesian Stock Exchange</td>
<td>146</td>
<td>146</td>
<td>145</td>
</tr>
<tr>
<td>The number of companies with uncompleted data</td>
<td>13</td>
<td>9</td>
<td>6</td>
</tr>
<tr>
<td>The number of financial statement that are not available in <a href="http://www.idx.co.id">www.idx.co.id</a> and Galeri Efek UAJY</td>
<td>3</td>
<td>2</td>
<td>2</td>
</tr>
<tr>
<td>The number of companies that using dollar on their financial statement</td>
<td>5</td>
<td>9</td>
<td>11</td>
</tr>
<tr>
<td>Number of observation</td>
<td>125</td>
<td>126</td>
<td>126</td>
</tr>
</tbody>
</table>

TABLE II
DESCRIPTIVE STATISTICS

<table>
<thead>
<tr>
<th></th>
<th>N</th>
<th>Minimum</th>
<th>Maximum</th>
<th>Mean</th>
<th>Std. Deviation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Expense Ratio</td>
<td>377</td>
<td>.00</td>
<td>15.46</td>
<td>.2038</td>
<td>.82044</td>
</tr>
<tr>
<td>Size of Board Commissioners</td>
<td>377</td>
<td>2.00</td>
<td>10.00</td>
<td>4.0637</td>
<td>1.69360</td>
</tr>
<tr>
<td>Independent Composition</td>
<td>377</td>
<td>.14</td>
<td>1.00</td>
<td>.3934</td>
<td>.11758</td>
</tr>
<tr>
<td>Size</td>
<td>377</td>
<td>20.62</td>
<td>32.36</td>
<td>27.4191</td>
<td>1.62603</td>
</tr>
<tr>
<td>Valid N (list wise)</td>
<td>377</td>
<td></td>
<td></td>
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<td></td>
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</table>

TABLE III
RESULT

<table>
<thead>
<tr>
<th>Model</th>
<th>Unstandardized Coefficients</th>
<th>Standardized Coefficients</th>
<th>t</th>
<th>Sig.</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>B</td>
<td>Std. Error</td>
<td>Beta</td>
<td></td>
</tr>
<tr>
<td>Constant</td>
<td>.858</td>
<td>.120</td>
<td></td>
<td>.000</td>
</tr>
<tr>
<td>Size of Board Commissioners</td>
<td>-.011</td>
<td>.004</td>
<td>-.133</td>
<td>-2.395</td>
</tr>
<tr>
<td>Independent Composition</td>
<td>-.121</td>
<td>.058</td>
<td>-.106</td>
<td>-2.085</td>
</tr>
<tr>
<td>Size</td>
<td>-.023</td>
<td>.005</td>
<td>-.271</td>
<td>-4.765</td>
</tr>
</tbody>
</table>

C. Hypothesis Test

Table III shows the result of test research hypothesis. Based on Table III, the regression model can be formulated as follows.

Expense Ratio = 0.858 – 0.011Size of Board Commissioners – 0.121Independent Composition – 0.023Size.

Based on the result, all independent variable significantly affect to dependent variable. Size of Board negatively affects to expense ratio at alpha 5%. Independent Composition also negatively affects to expense ratio at alpha 5%. Based on the result, the hypothesis one and two are supported.

The main purpose of this research is to give empirical evidence that size of board commissioner and proportion of independent commissioner affect agency cost. Expense ratio is as direct proxy for agency cost reflecting the managerial discretion to utilize company’s resources and shows the excessive expenditures for perquisites consumption. Higher ratio means higher agency costs because perquisites consumption exceeds the operational costs. Both independent variables (size of board commissioners and proportion of independent commissioner) negatively affect to expense ratio. These findings indicate when the numbers of board size increase; the expense ratio will decrease, as well as proportion of the independent commissioner increase and the number of expense ratio decrease.

Decreasing expense ratio is meaning that lower agency costs occur when there is increasing size of board commissioners or increasing proportion of independent commissioners on the board. These findings support previous research such as [27] that document the larger board size has significance effect to mitigate the agency cost. These findings also support previous research such as [7] documenting that the large powerful board helps the strategic decision making. The results of this study also support [28] documenting that smaller boards are assumed to have inadequate confidence and unclear understanding in making strategic changes. In company, board commissioner functions are to monitor and give advice to the directors in accordance with the corporation’s goal. When the numbers of board member increase, they will have different backgrounds, point of view, and experience in business. Those varied backgrounds will enhance the capability commissioners to monitor, control, and give advice to the directors. The monitoring and controlling by board commissioners, board directors can not abuse of power for their own interest easily. Otherwise, board directors will do good performance to be rewarded by shareholders.
V. CONCLUSION

The results of this research show that both alternative hypotheses are supported by the expense ratio proxy. The results mean that the increasing numbers of board commissioners and proportion of independent commissioners can mitigate or reduce agency cost. This research has some limitation due to the limited samples, samples period and the measurement of agency cost. This research only used the samples from manufacturing companies therefore it can not be compared with other industries. To measure agency cost, this research does not include some expense such as commissions charged by director to facilitate transactions and travel expense for executives. Therefore, this research can not fully reflect the managerial discretion in spending company expense for executives. Therefore, this research can not fully reflect the real situation of agency cost.

For future research, some suggestion could be given. First, further researches can add more sample with other industries such as banking and insurance to make comparative between one industries and another. Second suggestion regarding the proxies for agency cost. Further researches can obtain more information about commissions and some executive expense to reflect the real situtation of agency cost.

REFERENCES


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