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The Impact of Good Corporate Governance and Leverage on Financial Performance of Manufacturing Companies

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Abstract

This study aims to examine the impact of effective corporate governance and leverage on the financial performance of manufacturing firms publicly listed on the Indonesia Stock Exchange. This study employs a quantitative research strategy, utilizing various research methods, including normality testing, multicollinearity testing, and heteroscedasticity testing. Additionally, regression analysis is conducted, explicitly employing multiple linear regression analysis, hypothesis testing analysis, and calculating the coefficient of determination. The study's findings indicate a positive and statistically significant relationship between institutional ownership and financial performance. The presence of managerial ownership exerts a favorable and statistically significant impact on a firm's financial success. The company of independent commissioners has been found to have a clear and statistically significant effect on financial performance. The presence of an audit committee has been found to have a favorable and statistically significant impact on financial performance. The utilization of leverage, as indicated by the Debt-to-Asset Ratio (DAR), exhibits a noteworthy and positive effect on the financial performance of an entity. The positive test findings obtained suggest a positive correlation between a firm's leverage and its financial performance, indicating that as the leverage of a company increases, its financial performance is also expected to increase. This positive correlation can arise due to the prevalence of sample companies with a higher proportion of debt in their capital structure than their equity. The concurrent influence of effective corporate governance and leverage on a company's financial success is noteworthy. The financial success of a corporation can be predicted by utilizing many GCG variables, namely independent commissioners, audit committees, institutional ownership, and managerial ownership, together with leverage.

Keywords: Good Corporate Governance; Leverage; Financial Performance

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Introduction

One of the company's primary objectives is to optimize its financial gains. The company's financial performance indicates its ability to achieve maximum profit. Financial performance refers to the depiction of a company's fiscal state, typically evaluated through financial analysis techniques. Performance refers to the manifestation or exhibition of the current state or condition of the company. The present exhibit is elucidated via a comprehensive financial analysis, which will assess the company's overall financial standing, indicating whether it is in a favorable or unfavorable state. The study's outcomes directly correlate with the organization's financial performance, whether positive or negative. The assessment of a company's financial performance serves as a metric to evaluate the company's strengths and shortcomings during a specific timeframe. This evaluation aids management in making informed decisions. Evaluating financial performance can also show how well managers are doing at reaching the company's profit-boosting goals. Regarding investors, it might be a factor to consider while making investment decisions.

Evaluating a company's financial performance holds significance for various stakeholders, including management, shareholders, and governmental entities. The primary objective of evaluating a firm's financial performance is to incentivize personnel toward the attainment of organizational goals and adherence to established norms of conduct, hence facilitating the realization of desired outcomes and actions. Furthermore, an evaluation of the corporation's fiscal performance will be among the data that significantly impacts investment decisions. The challenges encountered by corporations in achieving substantial profits typically revolve around fundamental aspects, namely: (1) The imperative for the company to proficiently and effectively manage its resources across all functional domains (such as human resources, accounting, management, marketing, and production), (2) The establishment of a consistent separation system between management and shareholders, thereby enabling the company to mitigate potential conflicts of interest that may arise between these two parties, and (3) The necessity for the company to establish credibility with external investors, ensuring the appropriate and efficient utilization of external funds, and guaranteeing that management acts in the best interests of the company.

To overcome these obstacles, the company must have a good management system by implementing good corporate governance (GCG). Darmawati et al. (2004) state that GCG is one of the key elements in improving economic efficiency, which includes a series of relationships between company management, the board of commissioners, shareholders, and other stakeholders. GCG can also monitor contract problems and limit management's opportunistic behavior. This study's GCG mechanisms include institutional ownership, managerial ownership, independent commissioners, and audit committees. The company's financial performance will be good if the company can control the behavior of the company's top executives to protect the interests of the company owners (shareholders), one of which is the existence of an audit committee. The audit committee is expected to be able to oversee financial reports and external audits and watch the internal control system by the Decree of the Minister of State-Owned Enterprises Number: 117/M-MBU/2002. Because of their responsibility to manage internal controls and financial statements, GCG mandates that audit committees have a level of competence in finance. Another factor affecting financial performance is the level of debt (leverage). According to Jao and Pagalung (2011), leverage, one alternative source of corporate funds other than selling shares in the capital market, is through external sources of funds in the form of debt. The company will try to fulfill the debt agreement to get a good assessment from creditors.

Financial performance appraisal is a regular assessment of the operational efficiency of a business, its divisions, and workers concerning established goals, standards, and performance metrics. The evaluation of the company's financial success can be observed through the analysis of its financial statements and the examination of fluctuations in its stock prices. The primary objective of performance appraisal is to incentivize employees to attain organizational objectives and adhere to established behavioral benchmarks, hence facilitating the realization of desired outcomes and actions. Standards of behavior may manifest as management rules or formal goals delineated within the budgetary framework. Financial performance refers to the evaluation of specific metrics that might gauge a company's effectiveness in creating profits (Sucipto, 2003: 2). The attainment of favorable financial performance is a crucial objective for all companies, irrespective of their geographical location, as it serves as an indicator of the organization's proficiency in resource management and allocation. A corporation's financial performance refers to its capacity to elucidate its operational activities (Payatma, 2001) as cited in Sabrinna, 2010). Hastuti (2005) asserts that a corporation's financial performance is contingent upon many ongoing managerial actions. Hence, when evaluating the organization's financial performance, it is necessary to examine the collective financial and economic consequences of decisions and evaluate them using comparative metrics. Financial performance can serve as a gauge of an organization's effectiveness and efficiency in achieving its goals. The effectiveness measurement depends on the managerial capacity to select the appropriate tool to accomplish goals. The term "efficient" can be understood as a measure of the relationship between input and output.

The financial statements generated by the firm are a valuable source of information for evaluating the company's financial performance. These statements accurately depict the company's financial position within a specific timeframe. Financial reports are often used to assess a company's profit-generation performance, although they may only sometimes accurately reflect economic outcomes and circumstances. Analyzing a company's financial statements examines and evaluates its financial performance within a specific accounting period (Sucipto, 2003). Good Corporate Governance (GCG) is derived from agency difficulties resulting from the separation of ownership and control inside a firm. In the principal-agent relationship between capital owners and managers, the agency dilemma happens when the principal needs help keeping their invested assets safe from being stolen or put into businesses that will not make them any money. The utilization of GCG is essential in mitigating agency conflicts that arise between owners and managers. Good corporate governance (GCG) is a framework that elucidates the interplay among different stakeholders inside a corporation, ultimately influencing the firm's financial success trajectory. The Forum For Corporate Governance in Indonesia (FCGI) introduced various concepts of corporate governance (GCG) in its inaugural publication in 2003. Drawing from the definition provided by the Cadbury Committee, GCG is defined as a framework comprising regulations that govern the interactions between shareholders, management, creditors, government, employees, and other internal and external stakeholders. This framework establishes the rights and responsibilities of these parties, ultimately serving as a mechanism for directing and overseeing the company's operations.

The GCG is a systematic framework that state-owned enterprise entities use to improve business performance and ensure corporate responsibility with the ultimate goal of achieving long-term shareholder value while taking other stakeholders' concerns into account, according to the Decree of the Minister of State-Owned Enterprises Number KEP-117/M-MBU/2002. Ethical principles and legal regulations guide this framework. According to Kaen (2003), as cited in Siallagan and Machfoedz (2006), the concept of corporate governance (GCG) primarily revolves around the question of who should have authority over business activities and the rationale behind exercising control over them. The term "who" refers to the individuals or entities that hold shares in a company, but the word "why" pertains to the underlying reasons for this ownership, which can be attributed to the interactions and connections between shareholders and other parties having a vested interest in the company. Arifin (2005) gives another definition of corporate governance. He says that it is when all the people who have a stake in a company work together to ensure that it runs smoothly and in line with everyone's rights and duties. This concept emphasizes two key aspects. Firstly, it highlights the significance of shareholders' rights to access accurate and timely information. Secondly, it underscores the company's responsibility to provide precise, convenient, and transparent disclosures about its performance, ownership, and stakeholders.

A comprehensive comprehension of the issue of firm ownership necessitates a foundation rooted in agency theory. The present thesis explores the dichotomy between ownership and control within the organizational context. According to Jensen and Meckling (1976), the agency relationship can be defined as a contractual arrangement between the principal, the owner, and the agent, the management. A conflict of interest arises when the principal and agent have divergent interests, potentially leading to the agent's actions deviating from the principal's interests and resulting in agency costs. Furthermore, it can be observed that agents possess a more significant amount of information on the current condition of the organization in comparison to principals. This scenario presents potential avenues for managerial misconduct. Within the agency theory framework, managers are morally responsible for ensuring that the principals make as much money as possible by getting pay that is in line with the terms of the contract. Therefore, the corporation is characterized by two distinct interests, with each partner striving to attain or sustain the desired level of wealth (Irfan, 2002). Various alternatives are available to mitigate agency costs, including internal control systems, external control mechanisms, and market controls. Internal control methods are specifically devised to achieve a balance of interests between management and shareholders. Jensen and Meckling (1976) propose various strategies for mitigating agency costs, including augmenting managerial ownership of firm shares. This approach enables managers to experience the advantages resulting from their decision-making directly. Furthermore, the insufficiency of free cash flow might be attributed to the increase in the dividend payout ratio. Thirdly, one approach to augmenting funds is by boosting debt financing. Additionally, a fourth strategy involves engaging institutional investors as diligent overseers.

Leverage is the debt a company incurs to finance its assets. Leverage can be categorized into two distinct forms: operating leverage and financial leverage. Operating leverage is a metric that reflects the impact of fluctuations in sales volume on net income. In contrast, financial leverage pertains to a company's capacity to meet its debt obligations through its equity. Leverage is a quantitative measure that elucidates the correlation between the indebtedness of a corporation and its capital structure. According to Harahap (2013), this ratio shows how much the company depends on outside funding sources, like debt, compared to its resources, which are capital. Leverage is a quantitative metric employed in the examination of financial statements, serving to indicate the extent of collateral that is accessible to creditors. Fahmi (2012) posits that firms use leverage to maximize the advantages gained beyond the fixed expenses incurred. Debt refers to a contractual arrangement between a debtor, typically a firm, and a creditor. Creditors must evaluate the company's capacity to fulfill their financial obligations favorably within this debt agreement. The prevailing hypothesis in prior research posits that a debt contract agreement prompts management to engage in discretionary accruals to demonstrate favorable performance to creditors, thereby seeking to secure additional funding or debt payment rescheduling. According to corporate finance theory, the utilization of debt by companies offers various advantages in terms of managerial behavior. Firstly, debt incentivizes managers to exert more effort to mitigate the risk of business bankruptcy (Grossman and Hart, 1986). Secondly, debt encourages managers to allocate free cash to shareholders through debt repayment or reinvestment activities (Jensen, 1986). Lastly, debt plays a role in curbing managers' tendencies towards excessive perquisite consumption.

Research Design and Method

The location for obtaining data in this study is in Manufacturing Companies Listed on the IDX for 2017-2020. The type of data the authors use in this study is quantitative data. Quantitative data is data in the form of numbers related to research. The data source used is financial information data of manufacturing companies listed on the IDX during 2017–2020, obtained from ICMD. This study uses multiple linear regression analysis methods to measure hypothesis testing but to get maximum results, it is necessary to test classical assumptions with the help of the SPSS version 25 application.

Results and Discussion

Table 1. Multiple Linear Regression Test Results

Coefficients[a]

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	15.733	1.014		1.571	.530
	Institutional Ownership	2.166	.473	.094	4.579	.000
	Managerial Ownership	3.766	1.413	.137	2.665	.015
	Independent Commissioner	2.904	.741	.376	3.919	.000
	Audit Committee	7.499	1.895	.374	3.957	.000
	Leverage	.418	.129	.102	3.240	.004

a. Dependent Variable: Financial Performance
Source: Data processed, 2021

The results of the regression coefficient (β) obtained the following equation:

$$Y = 15.733{+}2.166X1.1{+}3.766X1.2{+}2.904X1.3{+}7.499X1.4{+}0.418.$$

The constant value of 15.720 indicates the expected effect on financial performance when all independent variables are zero. The positive regression coefficients for institutional ownership (2.166), managerial ownership (3.766), independent commissioners (2.904), audit committee (7.499), and leverage (0.418) indicate the percentage change in financial performance for every one unit increase in each of the independent variables. For example, a 1-scale increase in institutional ownership is associated with a 2.166% increase in financial performance, and the same interpretation applies to the other variables.

The One-Sample Kolmogorov-Smirnov Test indicates a Monte Carlo significance value of 0.335 (> 0.5), suggesting that the data is normally distributed. Multicollinearity testing, utilizing tolerance and Variance Inflation Factor (VIF) values, reveals values above 0.1 and below 10, respectively, indicating low correlation between independent variables and meeting the criteria for a good regression model. The heteroscedasticity test means that data points are randomly spread, with no discernible pattern above or below, signifying the absence of a heteroscedasticity problem. Lastly, the autocorrelation test, with a Durbin-Watson value of 2.296 compared to critical values, supports the conclusion that there is no positive or negative autocorrelation between variables. In summary, the regression model in this study is considered robust, meeting the necessary assumptions of normality, low multicollinearity, absence of heteroscedasticity, and no autocorrelation between the independent variables.

Table 2. Simultaneous Test Results (F Test)

ANOVA[b]

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	319.401	5	63.880	7.657	.000[a]
	Residual	108.452	13	8.342		
	Total	427.853	18			

a. Predictors: (Constant), Leverage, Audit Committee, Institutional Ownership, Independent Commissioner, Managerial Ownership
b. Dependent Variable: Financial Performance
Source: Data processed, 2021

The findings from table 2, based on data processed through SPSS version 25, reveal the results of simultaneous hypothesis testing using the ANOVA test or F test on regression. The analysis indicates that the independent variables collectively significantly influence the dependent variable. The calculated F value of 11.076, which is higher than the F table value of 2.02 (F count 11.076 > F table 2.02), and the significance level of 0.000, which is lower than the set threshold of 0.05, support this. Consequently, variables related to Good Corporate Governance (independent commissioners, audit committee, institutional ownership, and managerial ownership) and leverage are viable predictors for the company's financial performance.

Table 3. Partial Test Results (t-test)

Coefficients[a]

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	15.733	1.014		1.571	.530
	Institutional Ownership	2.166	.473	.094	4.579	.000
	Managerial Ownership	3.766	1.413	.137	2.665	.015
	Independent Commissioner	2.904	.741	.376	3.919	.000
	Audit Committee	7.499	1.895	.374	3.957	.000
	Leverage	.418	.129	.102	3.240	.004

a. Dependent Variable: Financial Performance

The results presented in table 3 show the relationship between various variables and financial performance. Institutional ownership significantly influences financial performance, as indicated by a sig. A probability value of 0.000, well below the 0.05 threshold. This shows that institutional ownership has a significant effect on financial performance. Managerial ownership also positively influences financial performance, with a probability of 0.015, reinforcing the significance of the regression coefficient and its positive impact.

Similarly, the Independent Commissioner variable positively influences financial performance, as the probability value of 0.000 shows statistical significance. The audit committee and leverage variables also positively affect financial performance, each with a probability of 0.000, underscoring the significant regression coefficient. In summary, the results of this study indicate that institutional ownership, managerial ownership, independent commissioners, audit committees, and leverage have a significant role in influencing financial performance.

Table 4. Determination Coefficient Test Results

Model Summary[b]

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.542	.514	.694	4.71040

a. Predictors: (Constant), Leverage, Audit Committee, Institutional Ownership, Independent Commissioner, Managerial Ownership
b. Dependent Variable: Financial Performance
Source: Data processed, 2021

Based on Table 4, the regression model I's coefficient of determination (Adjusted R Square) is 0, 694 or 69.4%. This means that the variation in GCG variables (independent commissioners, audit committees, institutional ownership, and managerial ownership) and leverage can explain 69.4% of the variation in financial performance variables and 30.6% (100 % - 69.4% = 30.6%) is defined by other causes outside the regression model.

Discussion

The study's findings demonstrate a noteworthy influence of favorable corporate governance factors on the overall performance of companies. The regression model encompasses crucial components, including independent commissioners, audit committees, institutional ownership, and managerial ownership, all exhibiting a noteworthy impact on firm performance. More specifically, a rise in institutional ownership is linked to increased supervision activities, which helps reduce opportunistic behavior and directs the company's attention towards attaining optimal performance. The ownership structure of a company has a significant impact on the management and board of directors. Institutional investors, in particular, are a robust mechanism for promoting Good Corporate Governance (GCG). They are capable of effectively monitoring and aligning the interests of management with those of shareholders. Moreover, managerial ownership has been recognized as a mechanism to mitigate agency conflicts by incentivizing managers to enhance their performance in alignment with shareholders' objectives. There is a positive correlation between the extent of share ownership by management and the degree of alignment between managerial and shareholder goals. The tale highlights the significance of ownership mechanisms in promoting organizational behavior that aligns with the interests of shareholders. This alignment is achieved through managers profiting from wise decisions and being held accountable for mistakes.

The subsequent discourse focuses on the significance of personal competence among independent commissioners, emphasizing integrity, business acumen, financial literacy, industry expertise, strategic thinking, leadership abilities, and practical communication proficiencies. The significance of capable autonomous commissioners in influencing company performance is acknowledged, emphasizing the requirement for persons possessing solid moral values, extensive expertise, and a dedication to acting only in the company's best interests while supervising the overall governance carried out by the board of directors. The study highlights the regulatory function of autonomous commissioners, underscoring the significance of effectively carrying out their supervisory job and upholding their autonomy in regulating board regulations. The conclusion affirms that a proficient and well-organized corporate governance system, encompassing ownership structures and efficient oversight, substantially improves company performance. The results are consistent with the previous research, as referenced in the study by Kusumaningrum (2015).

The presence of an audit committee variable has little influence on the financial performance of organizations. Audit committees, usually composed of two to three individuals and overseen by an autonomous commissioner, generally exhibit enhanced operational effectiveness when they have fewer members. However, this heightened efficiency is accompanied by a trade-off in the form of reduced diversity in terms of the collective experience of committee members. The research assesses the composition of audit committees in a sample of organizations, focusing on the number of members. The findings reveal that these committees often have two to three members, which diverges from the requirements outlined in the Sarbanes-Oxley Act, as discussed in Novi's (2010) paper. According to the Sarbanes-Oxley Act, audit committees are recommended to consist of five individuals selected for five years with a fundamental understanding of financial management. Out of the total membership of five individuals, two members are recommended to have the professional designation of public accountants, while the remaining three should not possess this particular qualification. It is recommended that the audit committee chair be filled by a committee member who is a public accountant and has not engaged in general accounting activities within the previous five-year period. It is of utmost significance that the chairperson and committee members are strictly barred from obtaining any remuneration from public accounting firms except pensions. The study highlights a disparity between the audit committee arrangements observed in the organizations sampled and the recommendations specified in the Sarbanes-Oxley Act. The provisions of the Act are designed to guarantee the presence of a comprehensive and informed audit committee that possesses the requisite skills and knowledge to supervise financial affairs efficiently and efficiently. The study's findings encourage contemplation over the necessity of harmonizing existing audit committee procedures with established regulatory standards. This underscores the significance of adhering to these rules for the effective operation of audit committees and their influence on financial performance.

The research findings shed light on a noteworthy correlation between leverage and financial success, suggesting that leverage directly impacts a company's overall performance. The association between higher leverage and increased risk implies that organizations should prioritize internal finance sources over external ones to enhance performance. Leverage refers to the strategic utilization of assets and fixed financial obligations to augment shareholder earnings, exhibiting a favorable influence on financial performance. The research, which explicitly examines the consumer goods sector, suggests that enterprises within this area demonstrate strong debt management practices, enhancing wealth maximization for company owners. The discovery above is consistent with the findings of Rahmadani and Rahayu (2017), whose research also demonstrates a positive correlation between leverage and financial performance. The available study proves that organizations with higher leverage tend to have superior financial performance. This may be attributed to their extensive utilization of borrowed capital, which exceeds their reliance on equity. Moreover, Black (2003) contributes valuable insights that enhance the understanding of the data by giving two alternate interpretations for the correlation between capital structure and the quality of corporate governance. The initial viewpoint suggests that organizations with higher debt levels are subject to more stringent supervision by creditors, reducing the necessity for rigorous internal control. The concept of external supervision, referred to as a replacement narrative, suggests that firms with greater debt levels may place less emphasis on internal governance processes due to the scrutiny imposed by external creditors. In conclusion, the findings of this research highlight the complex interplay between leverage, financial performance, and corporate governance within the consumer products industry. The relationship between leverage and financial success is often shown as an organization's deliberate decision, highlighting the importance of careful deliberation in debt management to get the best possible results.

Conclusions

In conclusion, the comprehensive investigation of study outcomes offers a sophisticated comprehension of diverse corporate governance and financial performance aspects. The regression analysis results indicate that many factors, such as institutional ownership, managerial ownership, independent commissioners, audit committees, and leverage, statistically impact financial outcomes. It is worth mentioning that institutional ownership is a reliable mechanism that indicates a robust framework of good corporate governance (GCG), which effectively aligns the interests of management with those of shareholders. Simultaneously, managerial ownership is recognized as a strategy to mitigate agency issues, promoting a direct congruence of interests between managers and shareholders. The significance of capable autonomous commissioners is underscored as crucial for efficient supervision, highlighting the importance of their qualities, expertise, and dedication to the organization's advantage. The impact of the audit committee's organizational framework and compliance with regulatory standards, including the Sarbanes-Oxley Act, is widely recognized as significant in determining financial performance.

Theoretical implications pertain to the significant influence of ownership arrangements and governance procedures on financial results. The existence of a favorable correlation between leverage and financial performance underscores the significance of strategic debt management as a pivotal factor in achieving organizational success. Furthermore, Black (2003) proposed a theoretical framework offers valuable insights into the complex dynamics between capital structure, external monitoring, and internal governance. These findings provide practical insights for firms seeking to enhance their financial performance by implementing a robust corporate governance system. Factors such as the constitution of audit committees, the proficiency of independent commissioners, and the tactical utilization of leverage can play a crucial role in augmenting financial outcomes. Strategic alignment of managerial and shareholder interests through suitable ownership arrangements is recognized as a pragmatic approach, underscoring the importance of organizations carefully negotiating these dynamics.

To enhance the depth of future research, it is recommended to investigate further the precise mechanisms by which ownership structures and governance practices influence financial performance. This approach has the potential to yield more comprehensive and nuanced insights. Further enhancing the existing body of knowledge can be achieved by investigating the industry-specific variations in the efficacy of these mechanisms and considering the contextual elements that influence their applicability. Moreover, examining the dynamic corporate governance environment in light of global economic transformations and regulatory modifications may provide insightful insights for future scholarly investigations.

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