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The Effect of Corporate Governance on Profitability as A Moderating Variable

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Abstract

This study investigates the impact of corporate governance on profitability, with Corporate Social Responsibility (CSR) serving as a moderating variable, focusing on chemical, pharmaceutical, and traditional medicine companies listed on the Indonesia Stock Exchange (IDX) between 2018 and 2023. Using panel data regression with a fixed effect model, the research finds that both independent commissioners and audit committees have a significant positive influence on profitability. The moderated regression analysis further reveals that CSR positively moderates the relationship between independent commissioners and profitability, while it negatively moderates the effect of audit committees on profitability. The findings suggest that enhanced corporate governance mechanisms, particularly the roles of independent commissioners and audit committees, contribute significantly to improved profitability. However, the varying moderating effects of CSR highlight the complexity of corporate governance dynamics. The study is limited by its five-year scope, industry-specific focus, and reliance on secondary data, suggesting that future research should expand the observation period, incorporate other sectors, explore additional moderating variables, and integrate primary data. These findings contribute valuable insights into the corporate governance practices within Indonesia's pharmaceutical sector.

Keywords: *Corporate governance; Profitability; Corporate Social Responsibility (CSR); Independent Commissioners; Audit Committee*

Introduction

In contemporary corporate development, profitability has become increasingly vital due to rapidly evolving global economic dynamics and intensifying competition. The digital era, characterized by rapid technological innovation and disruption, necessitates consistent profit generation for companies to invest in emerging technologies and maintain competitive advantages (Hizbandyah et al., 2023). Profitability serves as the primary barometer for evaluating corporate financial performance and ensures organizational sustainability (Janah & Munandar, 2022). Through robust profitability metrics, companies can reinvest in business development through production capacity enhancement, product innovation, or market expansion (Vernando et al., 2024). Furthermore, profitability strengthens employee confidence and morale while enhancing corporate negotiating positions with business partners (Cahyani & Sitohang, 2020). Return on Assets (ROA) represents a widely employed metric for assessing profitability, providing stakeholders with crucial insights regarding corporate performance and profit-generation potential.

The pharmaceutical industry demonstrates significant profitability variance, as evidenced by analysis of eight pharmaceutical companies listed on the Indonesia Stock Exchange between 2018-2023. SIDO exhibited the highest average ROA at 24.93%, followed by MERK at 26.21%, while KAEF recorded the lowest average at -0.86%, with an overall industry average of 10.99% (Annual Report, 2024). Such profitability fluctuations underscore the necessity for robust financial strategies and adaptive capabilities in navigating market dynamics and evolving industry challenges (Sari et al., 2023). Profitability enables pharmaceutical companies to increase investments in research and development, critical for product innovation and production efficiency enhancement (Wahyuningrum & Wulandar, 2023). Additionally, it facilitates production capacity expansion and environmental regulatory compliance, which is essential for mitigating ecological impacts. In the pharmaceutical sector specifically, profitability supports new drug development through funding for expensive and lengthy clinical trials while ensuring compliance with stringent regulatory requirements (Afiary et al., 2024).

Corporate governance, encompassing workflows, principles, and practices governing company operations and management, significantly impacts profitability and corporate performance (Wardoyo et al., 2021). Sound governance principles enhance investor confidence and mitigate risks, whereas governance deficiencies such as conflicts of interest or inadequate oversight can detrimentally affect profitability (Sari, 2021). During the COVID-19 pandemic, the Indonesian pharmaceutical industry experienced moderate demand increases, particularly for pandemic-related medications, while simultaneously confronting challenges in raw material procurement, with over 90% of materials being imported primarily from China and India (Saefurrohmat et al., 2022; Kardoko, 2020). This situation highlighted governance challenges in managing supply chain disruptions while maintaining operational efficiency.

Corporate Social Responsibility (CSR) functions as a principal instrument within corporate governance frameworks for implementing social initiatives. CSR practices typically involve corporate-level governance participation in social and environmental activities, enhancing corporate reputation through sustainable practices (Lu et al., 2021). During the COVID-19 pandemic, numerous pharmaceutical companies redirected their social responsibility programs toward disaster management through donations and pandemic response initiatives (Noviarty & Edryani, 2021). For instance, PT Kalbe Farma Tbk collaborated with doctorShare to provide personal protective equipment to 55 Indonesian hospitals (Handayani, 2020), while PT Indofarma Tbk donated 2,500 ampules of Vitamin C injections to state-owned hospitals for COVID-19 patient treatment (Indoalkes, 2020). Additionally, in 2022, nine national pharmaceutical companies donated medications and medical devices worth approximately Rp 22.5 billion to Sri Lanka during its economic crisis (Pressrelease.id, 2022).

Previous research presents inconsistent findings regarding corporate governance's relationship with profitability. Nuridah et al. (2023) determined that independent commissioners significantly influence corporate profitability, contradicting Riyandika & Saad's (2020) findings indicating no significant relationship. Similarly, Alabdullah & Ahmed (2020) identified significant correlations between audit committees and profitability, while Lumbanraja (2021) found no such association. Regarding moderation effects, Chijoke-Mgbame (2019) and Lu et al. (2021) demonstrated CSR's capacity to moderate relationships between audit committees and profitability, while Purbawangsa et al. (2020) established CSR's moderating influence on independent commissioner-profitability relationships. These research inconsistencies, potentially attributable to methodological variations, population differences, or disparate research objects, highlight the need for further investigation into how corporate governance practices and corporate social responsibility initiatives collectively influence financial performance in the pharmaceutical industry.

Analysis Method

This research employs quantitative methods based on positivist philosophy to examine relationships between variables through statistical analysis (Sugiyono, 2019). The population comprises Chemical, Pharmaceutical, and Traditional Medicine companies listed on the Indonesia Stock Exchange (IDX) from 2018-2023. Purposive sampling yielded eight companies meeting specific criteria: continuous IDX listing throughout the study period, annual report publication, and financial reporting in Indonesian Rupiah.

Independent variables include Independent Commissioners, measured as the ratio of independent commissioners to total board members (Purbawangsa et al., 2020), and Audit Committee, quantified as the total number of audit committee members. The moderating variable, Corporate Social Responsibility (CSR), employs content analysis methodology using GRI-G4 standards, which encompass 91 indicators across economic, environmental, and social dimensions. CSR disclosure is calculated using a binary scoring system (1 for disclosure, 0 for non-disclosure) divided by the total applicable indicators (Lubis, 2019). The dependent variable, profitability, is operationalized through Return on Assets (ROA), computed as net profit divided by total assets (Siswanto, 2021).

The analytical framework incorporates descriptive statistics for data characterization and panel data regression models including Common Effect, Fixed Effect, and Random Effect approaches. Model selection employs three statistical tests: Chow Test (comparing Common Effect and Fixed Effect models), Hausman Test (evaluating Fixed Effect versus Random Effect models), and Lagrange Multiplier Test (assessing Random Effect against Common Effect models). Hypothesis testing includes simultaneous testing (F-test), coefficient of determination (R^2), and partial testing (t-test), with significance established at 5% probability threshold (Widarjono, 2017).

The research additionally implements Moderated Regression Analysis (MRA) to examine CSR's moderating influence on relationships between corporate governance mechanisms and profitability. The regression equation incorporates interaction terms through multiplication of independent variables with the moderator (Ghozali, 2016). This analytical framework enables comprehensive assessment of direct effects of corporate governance components on profitability while simultaneously evaluating CSR's potential moderating influence on these relationships, providing robust empirical evidence regarding corporate governance dynamics within Indonesia's pharmaceutical sector.

Result and Discussion

Descriptive Statistical Analysis

Descriptive statistical analysis in quantitative research provides comprehensive variable characterization by transforming data into structured information through measurements like mean, median, mode, and standard deviation. This analysis establishes a foundation for subsequent inferential statistical analyses, facilitating valid and accurate data interpretation. This study analyzed 48 observations from eight Chemical, Pharmaceutical, and Traditional Medicine companies listed on the Indonesian Stock Exchange (IDX) from 2018-2023.

Table 1. Descriptive Statistical Analysis

Variable	N	Mean	Maximum	Minimum	Std. Dev.
Audit Committee	48	2.93	4.00	2.00	0.56
Independent Commissioner	48	0.50	0.75	0.25	0.12
CSR	48	0.38	0.53	0.14	0.10
Profitability	48	0.11	0.92	-0.05	0.14

Source: Eviews 13 Data Processing Results, 2024.

The Audit Committee variable averaged 2.93 members (minimum 2.00 at three companies, maximum 4.00 at Kimia Farma consistently during 2018-2023) with a standard deviation of 0.56. Independent Commissioner proportion averaged 0.50 (minimum 0.25 at Kimia Farma in 2020, maximum 0.75 at Pyridam Farma throughout 2018-2023) with a standard deviation of 0.12. CSR disclosure averaged 0.38 (minimum 0.14 at Tempo Scan

Pacific in 2019, maximum 0.53 at Kimia Farma in 2020) with a standard deviation of 0.10. Profitability averaged 0.11 or 11.2% (minimum -0.05 or -5.6% at Pyridam Farma in 2023, maximum 0.92 or 92.1% at Merck in 2018) with a standard deviation of 0.14.

Model Specification Test

The panel regression analysis employed three approaches: Common Effect Model (CEM), Fixed Effect Model (FEM), and Random Effect Model (REM). Under CEM, only the Independent Commissioner significantly influenced profitability (p = 0.002), while the Audit Committee did not (p = 0.759). FEM provided stronger explanatory power, with both governance variables being statistically significant (p = 0.000), and an R-squared of 0.772, indicating 77.2% of the variation in profitability is explained by the model. REM also showed significance in both variables, although with slightly lower explanatory power than FEM (R-squared = 0.529). Overall, FEM demonstrated the best fit, making it the most robust model for interpreting the relationship between corporate governance and profitability.

Table 2. Model Specification Test

Variable	CEM		FEM		REM	
	Coefficient	Prob.	Coefficient	Prob.	Coefficient	Prob.
C	-0.154	0.036	-0.417	0.000	-0.350	0.000
Independent Commissioner	0.515	0.002	0.875	0.000	0.781	0.000
Audit Committee	0.177	0.759	1.813	0.000	1.416	0.003
Prob(F-statistic)	0.001		0.000		0.000	
N	48		48		48	
R-Squared	0.255		0.772		0.529	
Adj. R-Squared	0.222		0.718		0.508	

Simultaneous Test

The simultaneous test (F-test) was conducted to assess whether the independent variables jointly influence the dependent variable. Referring to Table 4.7, the Fixed Effect Model yields a probability (F-statistic) value of 0.00, which is lower than the significance level of 0.05. This result indicates that the independent variables—independent commissioner and audit committee—have a statistically significant combined effect on profitability. In line with Widarjono (2017), when the p-value is less than alpha, the null hypothesis is rejected. Therefore, it can be concluded that both governance variables simultaneously impact the profitability of the firms under study.

Coefficient of Determination Test

The coefficient of determination (R^2) test evaluates the explanatory power of the model in describing the variation of the dependent variable. Based on Table 4.8, the Fixed Effect Model yields an Adjusted R-squared value of 0.71. This indicates that 71% of the variation in profitability can be explained by the independent variables—independent commissioner and audit committee—while the remaining 29% is attributed to other factors not included in the model. A relatively high R^2 value suggests that the model has strong explanatory power, meaning the corporate governance variables are effective in explaining changes in profitability.

Partial Test

The partial test (t-test) aims to determine the individual significance of each independent variable on the dependent variable. According to Table 4.9, both independent commissioner and audit committee exhibit p-values of 0.00, which are below the 0.05 significance threshold. This indicates that both variables have a significant partial effect on profitability. The independent commissioner has a coefficient of 0.87, suggesting a positive influence on profitability. Similarly, the audit committee's coefficient of 1.81 also reflects a strong and positive effect. These results imply that improvements in corporate governance mechanisms contribute meaningfully to increasing a company's profitability.

Table 3. Partial Test

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	-0.41	0.06	-6.06	0.00
Independent Commissioner	0.87	0.12	6.73	0.00
Audit Committee	1.81	0.48	3.73	0.00

Moderated Regression Analysis

Moderated Regression Analysis (MRA) involves evaluating interaction effects between independent variables and a moderating variable—in this case, Corporate Social Responsibility (CSR). As seen in Table 4.10, the interaction between independent commissioner and CSR (X1AM) yields a probability value of 0.00 (< 0.05) with a coefficient of 4.34, indicating that CSR positively moderates the relationship between independent commissioners and profitability. Conversely, the interaction between audit committee and CSR (X1BM) has a probability value of 0.01 (< 0.05) with a negative coefficient of -13.65, suggesting that CSR weakens the effect of the audit committee on profitability.

Table 4. Moderated Regression Analysis

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	0.05	0.21	0.25	0.80
X1A	-0.92	0.49	-1.85	0.07
X1B	8.08	2.42	3.33	0.00
M	-1.17	0.48	-2.43	0.02
X1AM	4.34	1.17	3.71	0.00
X1BM	-13.65	5.25	-2.59	0.01

The Influence of Independent Commissioners on Profitability

The first hypothesis (H1) in this study proposes that independent commissioners positively and significantly affect firm profitability. The partial test results support this hypothesis, indicating a positive and significant relationship, with a probability value below 5% and a positive coefficient. This finding aligns with previous studies, such as Nuridah et al. (2023), which highlight the significant role of independent commissioners in improving profitability among chemical, pharmaceutical, and traditional medicine companies listed on the Indonesia Stock Exchange (IDX) between 2018 and 2023. In these industries, independent commissioners are vital in strategic oversight due to their objectivity, as they are not involved in daily operations (Karunia & Rusfian, 2021). They help prevent conflicts of interest and ensure compliance with regulations, thus contributing to operational efficiency and enhanced financial performance (Sari et al., 2024).

The Financial Services Authority (OJK) Regulation No. 57/POJK.04/2017 mandates that at least 30% of a company's board must consist of independent commissioners, a requirement fulfilled by 95% of the observed firms. Their presence ensures stronger governance, encouraging prudent management decisions and long-term value creation (Wahyuwidi & Lusmeida, 2020). Independent commissioners enhance transparency and accountability, building stakeholder trust and enabling firms to access capital for innovation and expansion, ultimately improving profitability (Nuridah et al., 2023). They also mitigate opportunistic behavior by overseeing financial decisions more rigorously (Ummah et al., 2024) and provide strategic insights essential for product innovation and competitiveness in these research-intensive industries (Haryani & Susilawati, 2023; Octavia et al., 2020).

The Influence of Audit Committees on Profitability

The second hypothesis (H2) in this study posits that the audit committee has a positive and significant impact on profitability. The partial test results show that the audit committee does indeed exert a positive and significant influence on profitability, with a probability value of 0.00, which is less than the 5% significance level, and a coefficient indicating a positive effect on profitability. This finding aligns with the proposed hypothesis and is supported by research from Alabdullah & Ahmed (2020), which found a positive and significant impact of the audit committee on profitability in the chemical, pharmaceutical, and traditional medicine industries listed on the Indonesia Stock Exchange (IDX) from 2018-2023. The role of the audit committee in these sectors is crucial for enhancing profitability. The audit committee improves oversight and accountability in financial reporting, reduces the risk of errors and fraud, and ensures that financial statements accurately reflect a company's performance, thereby boosting investor confidence and contributing to profitability growth (Hasnati, 2022; Julythiawati & Ardiana, 2023).

According to the Financial Services Authority (OJK, 2015), an audit committee must consist of at least three members, including independent commissioners and external parties. In this study, 81.5% of pharmaceutical companies from 2018-2023 complied with the audit committee regulations, which positively impacted profitability. Effective financial oversight reduces the risk of errors and fraud, ensuring more accurate and transparent financial reporting, which builds investor trust and attracts more investment, ultimately improving financial performance (Fahmi & Nabila, 2020). The audit committee also promotes transparency and accountability, particularly in industries with stringent regulations, enhancing both investor confidence and consumer trust, which can lead to higher sales and profitability (Aji et al., 2023; Suciwati et al., 2021). Furthermore, the audit committee bridges management and shareholders, improving communication and fostering realistic expectations, which can stimulate additional investment and contribute positively to profitability (Ardyanti & Kurnia, 2023; Kholis et al., 2022).

The Influence of Independent Commissioners on Profitability as a Moderation Variable

The third hypothesis (H3) in this study suggests that independent commissioners have a positive and significant effect on profitability, with Corporate Social Responsibility (CSR) acting as a moderating variable. The partial test results indicate that CSR can moderate the relationship between independent commissioners and profitability, with a probability value of 0.00, which is less than the 5% significance level, and a coefficient indicating a positive and significant impact on profitability. This finding is consistent with the hypothesis and is supported by Purbawangsa et al. (2020), who found that CSR moderates the influence of independent commissioners on profitability in the chemical, pharmaceutical, and traditional medicine industries listed on the Indonesia Stock Exchange (IDX) from 2018-2023. The role of independent commissioners is vital for enhancing transparency and accountability in managing the company, ensuring that management acts ethically and responsibly toward various stakeholders, including employees, consumers, and the wider community (Atwiningsih & Pujianto, 2023). When companies implement effective CSR practices, it strengthens the positive influence of independent commissioners on profitability by improving the company's reputation among investors and the public (Nopriyanto, 2024).

CSR also fosters better relationships between companies and stakeholders. In industries like chemicals and pharmaceuticals, where social and environmental issues are major concerns, a company's commitment to CSR can enhance public and consumer trust (Afifah et al., 2021). Independent commissioners promoting CSR initiatives ensure that the company meets societal expectations, which can result in increased customer loyalty and higher sales. This demonstrates that the company is not solely focused on short-term profits but also on long-term sustainability (Riyanti & Raharjo, 2021). Furthermore, CSR helps companies manage risks effectively by addressing social and environmental factors that could lead to legal or reputational issues that might harm financial performance (Atwiningsih & Pujianto, 2023). Independent commissioners play a critical role in overseeing and ensuring the proper execution of CSR policies, preventing potential losses that could impact profitability (Lubis, 2019).

The Influence of Audit Committees on Profitability as a Moderation Variable

The fourth hypothesis (H4) in this study posits that the audit committee has a positive and significant effect on profitability, with Corporate Social Responsibility (CSR) acting as a moderating variable. However, the results of the partial test show that CSR weakens the relationship between the audit committee and profitability, with a probability value of 0.01, which is smaller than the 5% significance level, and a coefficient indicating a negative and significant effect on profitability. This finding contradicts the formulated hypothesis and is supported by research from Aprilliani & Totok (2018), which shows that CSR weakens the impact of the audit committee on profitability in the chemical, pharmaceutical, and traditional medicine industries listed on the Indonesia Stock Exchange (IDX) from 2018-2023. While the audit committee is responsible for overseeing financial processes and ensuring compliance with accounting standards, when CSR becomes a significant focus, attention and resources that should be allocated to financial audits can be diverted (Sukma & Ismail, 2023).

Intensive CSR implementation requires large investments in social, environmental, and community development programs, which can strain a company's operational budget (Lubis, 2019). The audit committee, focused on financial performance monitoring and strict internal controls, may experience diluted focus when the company engages in aggressive CSR activities (Hasnati, 2022). The committee must balance CSR fund usage with their primary goal of maintaining operational efficiency and ensuring that the budget is optimally used for business objectives. In industries like chemicals and pharmaceuticals, where regulatory pressures and research demands are high, CSR can add significant costs and complicate financial oversight (Prayogi et al., 2024). The increased CSR budget may make it difficult for the audit committee to balance cost control and profitability, ultimately weakening its positive impact on net income (Wibowo, 2022). Furthermore, CSR's emphasis on social goals can shift the company's focus from financial targets to social reputation, making audit committee oversight on profitability less effective (Sutrisno et al., 2024).

Conclusion and Recommendation

This study aims to assess the impact of corporate governance on profitability, using CSR as a moderating variable, specifically in chemical, pharmaceutical, and traditional medicine companies listed on the Indonesia Stock Exchange (IDX) from 2018 to 2023. The panel data regression with the fixed effect model indicates that both independent commissioners and audit committees have a significant and positive influence on firm profitability. Furthermore, the moderated regression analysis reveals that CSR positively moderates the relationship between independent commissioners and profitability. However, it negatively moderates the influence of audit committees on profitability.

Several limitations must be noted. First, the five-year research span may not fully capture long-term trends. Second, the study's industry focus limits generalizability to other sectors. Third, CSR shows varying moderating effects, indicating a need to explore additional influencing variables. Fourth, the exclusive use of secondary data, such as published financial statements, restricts deeper insights into corporate practices. Lastly, the fixed effect model may not account for all external variables, such as macroeconomic conditions. Future research is encouraged to expand the observation period, include other industries, consider alternative moderating variables, and integrate primary data (e.g., interviews or surveys). Using different regression models could also help test the robustness of the findings more thoroughly.

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