Corporate Governance, CEO Tenure and Capital Structure

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ABSTRACT

The purpose of this paper is to examine the effect of corporate governance on capital structure with moderation effect of CEO tenure in manufacturing firms. The data in this study is collected from the annual report published. The data cover the period from 2013 to 2017. Multiple linear regression model and moderated regression analysis are used in this research. Capital structure as dependent variable is measured by ratio of total debt to total assets. Corporate governance is independent variables which is measured by proportion of independent commissioners. The novelty of this research examines CEO tenure as moderation variables proxied by how many years the CEO leads the firm and how it can affect the influence of independent commissioners on capital structure which is rarely studied. The results showed that independent commissioners as an independent variable has positive effect on capital structure, while CEO tenure weakens the positive effect of independent commissioners on capital structure. The results of this study can help the firms to pay attention to the corporate governance and CEO tenure because they can affect the firm's capital structure policy.

Keyword: corporate governance, independent commissioner, ceo tenure, capital structure

INTRODUCTION

The firm's decision in choosing a source of funding is the important decisions for management because it can impact the value of the firm and the firm's stock price. The sources of funding are obtained from two alternative sources; namely internal and external funding sources. Sources of internal funds generated within the firm and showed how the firm obtain its profit (in the form of retained earnings), while external sources of funds come from outside the firm (bank loans, bond issuance and shares). Capital structure is a combination of debt and equity (Tarus and Ayabei, 2016). In determining the composition of financing sources, management needs to determine the optimal capital structure that is capable to maximize firm value. The use of debt as a chosen financing source has its own advantages and disadvantages. The advantage of using debt is obtained from the benefits of tax deduction and managers become more disciplined because they have obligation to repay the debt and its interests. Meanwhile, debt can also cause losses, namely bankruptcy costs. Bankruptcy costs arise from the use of a disproportionate debt compared to the ability of the firm which will cause a failure of the firm in paying interest and debt principal that must be paid. The implication is a firm must be more careful in making its capital structure decisions for the survival of the firm.

The research conducted by Tarus and Ayabei (2016) explains that capital structure can be influenced by corporate governance. The governance literature explain that corporate governance can provide solutions in overcoming agency conflict between several parties related to the firm: insiders (manager) and outsiders (shareholders). Proportion of independent commissioners can be used for corporate governance measurement (Tarus and Ayabei, 2016). The composition of the board of commissioners in Indonesia are regulated in POJK (Peraturan Otoritas Jasa Keuangan), which explains that the board of commissioners consists of 2 (two) members of the board of commissioners with 1 (one) of whom are independent commissioners. In addition, the number of board of commissioners must consists of more than 2 (two) members of the board of commissioners with the number of independent commissioners required to be at least 30% (thirty percent) of the total members of the board of commissioners.

In this study, we investigate how the presence of independent commissioners are related to the capital structure of the firm. The number of independent commissioners reflect the more effective performance of the board of commissioners, this will make corporate governance in a firm also better. The increasing proportion of independent commissioners in a firm shows that the firm has good corporate governance. This is because independent commissioners make the performance of the board of commissioners in carrying out their supervisory and advisory functions to the board of directors more effective, one of which is realized by reporting reliable financial information, so information asymmetry will decrease. Firms with good corporate governance that are reflected in the increasing proportion of independent commissioners will cause firms to have greater access to external funding (Claessens and Yurtoglu, 2013). This is because the creditor believes that the firm is able to repay the debt and interest properly. Creditors' trust causes the cost of debt to be lower because the default risk in the firm is getting lower. This makes the firm more interested in increasing the level of debt that can be used to increase its investment in the development of the firm 's business.

Capital structure decisions can also be influenced by the tenure of the CEO who is leading the firm. The CEO has the responsibility to lead, direct, coordinate, control and oversee the implementation of general policies, regulations and operational tasks of the firm in accordance with the vision, mission, business goals and strategies that are applied. CEO tenure in Indonesia varies greatly and this can affect the level of debt. If CEO's tenure getting longer, it will make the level of debt in the firm higher. A CEO who has a longer tenure makes the CEO more confident and bolder in taking risks from the use of debt (Orens and Reheul, 2013). Longer CEOs have more knowledge and skills in managing debt. Therefore, creditors will increasingly trust the firm led by the CEO with a longer tenure. Research conducted by Tarus and Ayabei (2016) examined CEO tenure as a moderating variable in the relationship between proportion of independent commissioners and capital structure. The longer the CEO has served in a firm will cause the positive effect of proportion of independent commissioner on the capital structure will be weaker. This is because firms are less dependent on their corporate governance in obtaining debt because the role of corporate governance will be replaced by the CEO with a longer tenure. The longer the CEO has served in a firm, the more creditor will believe in providing loan to the firm and less take into account whether the firm to be given the loan has good corporate governance or not. This is because creditors give confidence to the CEO who has long served because the CEO's experience in managing debt is longer.

In addition to the main factors that have been explained previously there are other factors that affect the capital structure as a control variable consisting of the firm size and firm age. The study examines the relationship of corporate governance as measured by the proportion of independent commissioners on capital structure with CEO tenure as moderating variables is still rarely a concern of researchers in Indonesia. Therefore, the purpose of this study was conducted to determine the effect of proportion of independent commissioners on capital structure with the moderation effect of CEO's tenure in manufacturing firms listed on the IDX from 2013 to 2017.

THEORITICAL FRAMEWORK

Capital Structure

Capital structure is a combination of debt and equity in funding investment of the firm (Tarus and Ayabei, 2016). The measurement commonly used to calculate capital structure of the firm is financial leverage (Detthamrong et al., 2017). Financial leverage shows the level of use of financial resources that causes a fixed cost, in the form of debt which causes interest cost. Total debt to total assets ratio is a measurement that commonly used for measure financial leverage (Detthamrong et al., 2017; Setiawan and Syarif, 2019). Therefore, the measurements used to measure capital structure of the firm is ratio of total debt to total assets**.**

Corporate Governance

Corporate governance is commonly interpreted as a group of rules governing the relationship among the parties related to the firm: shareholders (both majority and minority shareholders), the directors or management that lead the firm, creditors, government, employees, and stakeholders who have a relation to their rights and obligations. Good corporate governance needs to be implemented properly and correctly by the firm because it can increase shareholder value in the long run. In Indonesia, corporate governance uses a two tiers system, meaning that the firm has two separate bodies between the board of commissioners who perform supervisory and advisory positions and the board of directors who performs managerial functions. The board of commissioners also has the authority to be able to appoint and dismiss a director in the firm.

Independent Commissioner

Good corporate governance will be achieved if in the firm have mechanism that regulates the procedures and relationships between the parties that make decisions with those who exercise control and supervision of these decisions. This study focuses on one mechanism that exist in corporate governance that are used as a tool to overcome agency problems, it is proportion of independent commissioners. Independent commissioners are appointed based on the decision in the General Meeting of Shareholders (GMS). The member came from parties who are not affiliated with the main shareholders, members of the board of directors and / or other members of the board of commissioners (UUPT No. 40 of 2007 Article 120 paragraph 2). The role of the independent commissioner is very important to sustainability of the firm. The existence of an independent commissioners can encourage the firm to achieve good corporate governance because they can guarantee the supervision and advice mechanism by the board of commissioners to the board of directors run more effectively and in accordance with statutory regulations.

CEO Tenure

The Chief Executive Officer (CEO) is someone who holds the highest position in the firm's operational activities, responsible for strategic plans and decisions and as a liaison between internal and external parties. The CEO tenure shows how many years the CEO has served in the analyzed firm (Morellec, 2012). The term of office of the CEO is stipulated in POJK Number 33 of 2014 Article 3 paragraph 3 which explains that 1 period of a member of the board of directors is no more than 5 years or until the closing of the annual GMS at the end period. Members of the board of directors are elected for a specified period and can be re-appointed (UUPT Number 40 of 2007 Article 94).

RESEARCH METHOD

The secondary data are used in this research. Secondary data is primary data that has been processed before. The data in the study were obtained from Indonesia Stock Exchange (Bursa Efek Indonesia). In this study, manufacturing firms are the population that listed in Indonesia Stock Exchange (IDX) for 2013-2017 period, all of the firms are the object to be selected by purposive sampling in representing the population. The analytical model used in this study is multiple linear analysis and moderated regression analysis. Testing of the analysis model is carried out to determine how the effect of independent commissioner on capital structure that is moderated by CEO tenure and controlled by firm size and firm age. Furthermore, the data process has been done by SPSS. Model to examine the hypothesis in this study are:

Model 1:

$$TDTA_{i,t} = \alpha + \beta_1\ IND_{i,t} + \beta_2\ SIZE_{i,t} + \ \beta_3\ AGE_{i,t}$$

Model 2:

$$TDTA_{i,t} = \alpha + \beta_1\ IND_{i,t} + \beta_2\ TEN_{i,t} + \ \beta_3\ (IND * TEN)_{i,t}\ \beta_4\ SIZE_{i,t} + \beta_5\ AGE_{i,t}$$

Table 1. Research Variables and Measurement

	Measurement
Capital Structure (Detthamrong et al., 2017)	$TDTA_{i,t} = \frac{\text{Total Debt}_{i,t}}{\text{Total Assets}_{i,t}}$
Independent Commissioner (Tarus and Ayabei, 2016)	$IND_{i,t} = \frac{\sum \text{Independent Commissioner}_{i,t}}{\sum \text{Number of Independent Commissioner}_{i,t}}$
CEO Tenure (Morellec, 2012)	$TEN_{i,t} = \text{Current year}_{i,t} - \text{Year became CEO}_{i,t}$
Firm Size (Setiawan and Rachmansyah, 2019)	$Size_{i,t} = \text{Ln (Total Assets)}_{i,t}$
Firm Age (Thanh, 2017)	$AGE_{i,t} = \text{Research year}_{i,t} - \text{Establish year}_{i,t}$

RESULT AND DISCUSSION

This study used secondary data from manufacturing firms listed on the Indonesia Stock Exchange for 2013-2017. This research uses 266 observations (exclude outlier data). Table 2 showed a statistical description of the research sample. The regression results from panel data processing are shown in table 3, and parameter values can be estimated, which shows the effect of the independent variables on the dependent variable.

Table 2. Descriptive statistics results

	N	**Minimum**	**Maximum**	**Mean**	**Standard Deviation**
TDTA	266	0.0662	0.9173	0.3852	0.1751
IND	266	0.3000	0.8000	0.4135	0.0937
TEN	266	1	37	9.8835	8.5560
BSIZE	266	2	11	4.0338	1.8619
SIZE	266	25.6199	33.0950	28.1708	1.5215

AGE	266	4	86	34.4737	12.8768
Valid N (listwise)	266				

Table 2 bellow gives an overview of the overall characteristics during the period 2013 - 2017 in manufacturing firms listed on Indonesian Stock Exchange. Capital structure (TDTA) in this study has average TDTA of 38.52%. Maximum value of capital structure is 91.73% which gives the highest value of capital structure. The minimum value of TDTA of 6.62% determines the lowest value of capital structure. Independent commissioner has the mean 41.35% means that the firms have proportion of independent commissioner more than required, which is 30%. CEO tenure has the mean scores of 9.8835 means that the tenure of CEO is 10 on average. Based on the table 3, the panel data regression test result from the manufacturing firms that has been sampled can be explained as follows:

Table 3. Panel Data Regression Test Results

Dependent Variable:	**TDTA**	
Regression:	**MLR**	**MRA**
Analysis Model:	**(1)**	**(2)**
Intercept	-0.172 (0.452)	**-0.393* (0.079)**
IND	**0.280** (0.015)**	**0.589*** (0.002)**
TEN		**0.021*** (0.000)**
IND*TEN		**-0.034*** (0.006)**
SIZE	**0.020** (0.025)**	**0.020** (0.020)**
AGE	**-0.002* (0.024)**	**-0.001* (0.095)**
Observation	266	266
R-Square	0.070	0.174
F-Statistics	**4.911*** (0.001)**	**9.099*** (0.000)**

Relationship between Independent Commissioner and Capital Structure

Independent commissioner has a significant positive effect on capital structure (coefficient 0.280 with a significance <5%). The significance value of independent commissioner as an independent variable is below a significant level. It means **H_0 is rejected, while H_1 is accepted**. This shows that if the proportion of independent commissioner in the firm increases, the debt level owned by the firm will be higher. The results of this research are supported by Tarus and Ayabei (2016), which shows that there is a positive relationship between the independent commissioner and the capital structure. Independent commissioners encourage the board of commissioners to supervise and give advice to directors effectively and provide value added to the firm. The higher proportion of independent commissioners in a firm, make the firms have better corporate governance. Independent commissioners can optimize the function of the board of commissioners in supervising and giving advice to the board of directors. It causes firms to have greater access to external funding because creditor believes that the firm is able to repay the debt and interest properly (Claessens and Yurtoglu, 2013). Firm can obtain external funds more easily with lower debt costs because the default risk of the firm is getting lower. This makes the firm more interested in increasing the level of debt that can be used to increase its investment in the development of the firm's business.

Moderating Effect of CEO Tenure on Relationship between Independent Commissioner and Capital Structure

Interaction between independent commissioner (IND) and CEO tenure (TEN) has a significant negative effect on capital structure (coefficient -0.034 with a significance <1%). This result is accept H2. CEO tenure weakens the positive effect of the independent commissioner on the capital structure. On the creditor side, the decision to make a loan does not take into account how many proportions of the independent commissioner the firm had when the firm was led by the CEO with a long tenure. The longer of CEO's tenure, the higher the level of debt usage in the firm. In addition, as tenure increase CEOs have more knowledge and abilities in managing debt. Therefore, creditors will believe in providing loans to firm led by CEOs with a longer tenure. Creditors will be more confident in providing loan to the firm with a longer CEO tenure because the ability of the CEO is better so that the role of the number of independent commissioners will be replaced by the CEO with a longer tenure.

CEO who has long served in a firm shows that the CEO has longer experience in managing the firm. The CEO is also believed to be able to manage resources better because he has known the characteristics of the firm for a longer time and has better access to firm information. A CEO who already has experience leading a firm will be judged to be more able to improve firm performance. A longer CEO may cause the firm to be less dependent on the merits of corporate governance. This is because CEO who have long tenure has confidence and courage in taking risks from the use of debt (Orens and Reheul, 2013). This causes the role of corporate governance to be replaced by the CEO with a longer tenure.

Effect of control variables on capital structure

Firm size (SIZE) has a significant positive effect on capital structure. These results are consistent with research conducted by Sheikh and Wang (2011). Larger firms have lower financial difficulties and bankruptcy risks. Firms with lower financial difficulties can obtain debt more easily at low cost because creditors believe the firms are able to repay their debt well (Lardon et al., 2017). This will attract firms to increase their use of debt in funding their investments. Firm age has a significant negative effect on capital structure. A firm that has long been established has a lower debt level because the firm has a low growth rate and the firm already has accumulated internal funds in a longer timeframe (Lardon et al., 2017). Therefore, compared with the use of funds from external sources through debt, old firms tend to use internal funds.

CONCLUSSION

This research was conducted to determine the effect of corporate governance proxied by proportion of independent commissioner on the capital structure with CEO tenure as moderating variables. The results from this study showed that the proportion of independent commissioners have a significant positive effect on capital structure. The higher proportion of independent commissioners, the higher the level of debt in the firm. Furthermore, CEO tenure weakens the positive effect of the proportion of independent commissioners on the capital structure. The results can help the firms to pay attention to the corporate governance and CEO tenure because they can affect the firm’s capital structure policy. In addition, creditors need to pay attention to the proportion of independent commissioner in making lending decisions to the firms.

Limitation of this study lies in the use of samples that only manufacturing firms on Indonesia Stock Exchange (IDX) and this study only use proportion of independent commissioners as corporate governance mechanism. Next study may include non-financial firms and other corporate governance mechanisms. Better sample might represent population characteristics. the greater level of confidence desired, the more samples are needed. Suggestions for future researchers to add factors that affect capital structure so that the analysis can provide more accurate inference.

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