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Reciprocal Capital Structure and Liquidity Policy: Implementation of Corporate Governance toward Corporate Performance

Sumani SUMANI¹, Ahmad ROZIQ²

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Abstract

The research objective examines the effect of corporate governance on capital structure and its effect on liquidity policy and corporate performance. It tests the effect of capital structure and liquidity policy on corporate governance. It also examines the effect of liquidity policy on capital structure and the effect of capital structure on liquidity policy. The study population is all manufacturing companies that went public on the Indonesia Stock Exchange in the period 2010-2019. The research population is 182 manufacturing companies. The Judgment Sampling was used and 109 companies meet the research criteria. The study used panel data for ten years so that the amount of data observed was 1090 observations. The analysis tool uses Warp Partial Least Square (WarpPLS). The results showed that corporate governance had a significant positive effect on capital structure, but corporate governance had a significant adverse effect on liquidity policy, and corporate governance had a significant positive effect on corporate performance. Furthermore, capital structure has a significant negative effect on corporate performance, but liquidity policy has no significant effect on corporate performance. Capital structure and liquidity policy are proven to be reciprocally significant positive correlations for manufacturing companies in Indonesia.

Keywords: Corporate Governance, Capital Structure, Liquidity Policy, Corporate Performance

JEL Classification Code: G34, D24, O16, G38, L25

1. Introduction

Is corporate governance still a problem in a country's business and economy? It is an interesting question in theoretical studies and among business people, especially in Indonesia. According to a study conducted by the World Bank, the weak implementation of the corporate governance system is one of the determinants of an acute crisis that occurred in Southeast Asia (World Bank, 1998, 2000, 2002). Besides, corporate governance also has a crucial role in increasing competition with global companies (Ehikioya, 2009).

Different theories have explained corporate governance issues. Agency theory is put forward (Fama & Jensen, 1983; Jensen & Meckling, 1976), which is at the center of many explanations for the link between corporate governance and firm performance. Williamson (1979, 1981, 1984) suggested a transaction cost economics where the firm itself is a governance structure facing a set of contractual hazards. Shleifer and Vishny (2012) suggest a financial model under which the corporate governance system should ensure that substantial resources are managed efficiently and in the interest of the suppliers of capital, mitigating the expropriation of resources by managers.

Jensen and Meckling (1976) assert that agency problems arise when managing a company is separate from its owner. Corporate governance is a means to make companies better, among others, by inhibiting practices of corruption, collusion, nepotism, improving budget discipline, utilizing supervision, and encouraging efficiency in corporate management (Zarkasyi, 2008). According to the agency theory, if this monitoring function can be carried out properly, it will reduce agency problems. It is explained by Macey and O'Hara (2003) that corporate governance is needed to reduce agency problems between owners and

¹First Author and Corresponding Author. Associate Professor, Department of Management, Faculty of Economics and Business, University of Jember, Indonesia [Postal Address: Kampus Tegalboto, Jl. Kalimantan No.37, Kabupaten Jember, Jawa Timur 68121, Indonesia] Email: sumani@unej.ac.id

²Associate Professor, Department of Accounting, Faculty of Economics and Business, University of Jember, Indonesia. Email: ahmad.roziq@unej.ac.id

managers. The larger number of audit committee members is expected to carry out more effective oversight. Increasing the number of members of the audit committee will increase confidence in supervision by the audit committee, because there are diverse experience and expertise, so it is expected to reduce agency problems in the company in the form of less optimal liquidity management (Karamanou & Vafeas, 2005). According to Chtourou et al. (2005), with a bigger number of boards, the monitoring mechanism of company management will be better. Taken together, theoretical and empirical studies using agency theory as a theoretical framework suggest that conflicts of interest between managers and shareholders, managerial incentives, controlling shareholders' motives, and the existing corporate governance structure in the firm have a significant influence on the capital structure choices made by managers (Jensen & Meckling, 1976; Berger et al., 1997; Faccio, Lang, & Young, 2010; Vijayakumaran & Vijayakumaran, 2019). Therefore, a firm's observed capital structure is the result of the combination of managers' incentive, controlling shareholders' objectives, and the robustness of the governance mechanisms in place to ensure the interest of outside shareholders or minority shareholders as well as the traditional financial determinants that have been typically used to explain capital structure choices.

The country has a growing, advanced, and robust industry. If the contribution of the manufacturing industry is at least 40% of GDP, Indonesia is still far below that limit (Hartanto, 2014). Nevertheless, the results of the Indonesian Manufacturing Purchasing Manager Index (PMI) survey published by the Nikkei and IHS Markit Bernard Aw amounted to 51.2 in December 2018, up from the previous month's achievement of 50.4. However, the global manufacturing index in December 2018 is at the lowest level since September 2016, which is 51.5, down from November 2018, which reached 52.0. This condition is caused by the continued decline in sales to foreign markets (Kontan.co.id., 2019). Based on the problems that have been raised previously, the importance of the research is in determining the Reciprocal Capital Structure and Company Liquidity Policy: Implementation of Corporate Governance on Company Performance.

2. Literature Review

2.1. Corporate Governance and Capital Structure

Studies have pointed out (Fidanoski et al., 2013; Motjaba et al., 2014; Mudalige & Ekanayake, 2017; Orazalin et al., 2016; Fidanoski et al., 2013; Motjaba et al., 2014; Orazalin et al., 2016; Mudalige & Ekanayake, 2017) that corporate governance proxies can be institutional ownership, managerial ownership, the board of directors, domestic

ownership, ownership concentration, board independence, auditors' opinions, ultimate ownership, state ownership, the role of quality, board meetings, remuneration committee, CEO education, corporate disclosure, and number of meetings held.

Myers and Majluf (1984) and Safdar and Hasan (2009) found that corporate governance has a significant effect on capital structure. Nevertheless, Motjaba et al. (2014) found evidence that corporate governance did not affect capital structure. Furthermore, Siromi and Chandrapala (2017) explained that the composition of the board a significant positive effect and board committee have a significant adverse effect on capital structure; the board size, CEO duality, and managerial ownership have no significant effect on capital structure. According to Liao et al. (2015), corporate governance (board composition, CEO duality, ownership concentration, and profitability) has a significant negative relationship with the debt ratio; corporate governance (board size) shows a significant positive relationship with the debt ratio.

According to studies (Chen & Hu, 2012; Fama & Jensen, 1983; Jensen & Meckling, 1976; Sun et al., 2016), at a low level of managerial ownership, ownership structure has a significant positive effect on capital structure, but in groups of companies with high managerial ownership levels, ownership structure has a significant adverse effect on capital structure. Furthermore, institutional ownership has a positive effect on the level of corporate leverage. Shyu (2013) shows ownership structure, proxied by insider ownership, has a significant negative effect on company performance. Su (2010) also explains that companies controlled by the government use less debt financing.

H1. Corporate Governance influences Capital Structure

2.2 Corporate Governance and Liquidity Policy

High liquidity in companies may be an indication of agency problems due to differences in interests between principals and agents (Jensen, 1986). Managers prefer the existence of substantial cash because this form of liquid assets is the easiest that can be used by managers for their welfare (Myers & Rajan, 1998). Alternatively, in other words, agency problems are one of the essential determinants in a company's liquidity policy (Dittmar et al., 2003). Agency problems that occur in companies can be minimized by applying good corporate governance, one of which is by determining the optimal level of liquidity (Jensen & Meckling, 1976).

Dittmar et al. (2003) found that companies with bad corporate governance, tended to have higher cash balances compared to companies with good corporate governance. Bokpin et al. (2011) and Luo and Hachiya (2005) found a positive relationship between foreign ownership and

corporate cash holding. However, if corporate governance is proxied by managerial ownership, the results are negatively correlated with cash holding (Bokpin et al., 2011; Papaioannou et al., 1992).

The application of corporate governance with the proxy of managerial ownership will build harmony between the interests of principals and agents so that managers act according to the wishes of shareholders (Jensen & Meckling, 1976). If managerial ownership is low, then the incentive for the manager to misuse company assets through the accumulation of cash holding will be higher, so that it can reduce the value of shareholders. Nevertheless, if managerial ownership is high, then managers will be motivated to increase the value of the company and be wiser in the use of company cash. Ozkan and Ozkan (2004) support that there is a significant positive relationship between managerial ownership and cash holding. Luo and Hachiya (2005) also find that insider ownership has a positive effect on the company's cash holding level. Christina and Ekawati (2014) and Luo and Hachiya (2005) found that institutional ownership negatively affected the company's cash holding. Corporate liquidity policy is proxied by cash holding, current ratio, liquid ratio, absolute liquid ratio, cash conversion cycle, and working capital (Bagchi & Chakrabarti, 2014; Bokpin et al., 2011; Wasiuzzaman, 2019).

H2. Corporate Governance influences Liquidity Policy

2.3. Corporate Governance and Corporate Performance

Company performance is the result of activities in return on investment within a specified period. Company performance is used for evaluation and in the decision-making by certain parties. Performance evaluation can be divided into two categories, namely, based on financial performance and based on market information (firm value). According to Ross et al. (2010), firm value is the same as the market value of debt and equity, minus cash and cash equivalents of the company. Saidat et al. (2019) shows that corporate financial performance is proxied by return on assets (accounting-based) and Tobin's Q (market-based), and has a significant adverse effect on the performance of family firms. In non-family firms, there is no systematic relationship with corporate performance (Nguyen & Nguyen, 2020).

Corporate governance has a significant positive effect on corporate performance (Bhatt & Bhatt, 2014; Kasozi & Ngwenya, 2010; Myers & Majluf, 1984; Orazalin et al., 2016). There was a significant positive relationship between corporate governance (board composition and board size) and financial performance. Ownership structure which is proxied by insider ownership and institutional ownership has

a significant positive effect on corporate performance (Lin & Fu, 2017; Shyu, 2013). However, Alucha and Bogumil (2017) show that corporate governance proxied by the concentration of ownership by majority shareholders have a significant adverse effect on corporate performance. In contrast, Mollah et al. (2012) showed that scattered ownership could improve corporate performance and reduce agency conflict. Mardnly et al. (2018) shows that corporate governance that is proxied by board of directors, auditing, disclosure, and ownership structure, apparently, only ownership structure has a significant positive effect on corporate performance (return on assets and earnings per share). Furthermore, in the ownership structure, only foreign ownership items have a significant positive effect on corporate performance. Ofoeda (2017) also shows a positive relationship between board size, audit committee size, meetings of the audit committee, and profitability.

H3. Corporate Governance influences Corporate Performance

2.4. Capital Structure and Corporate Performance

Capital structure is one of the important decisions in the field of corporate finance and refer to the way that a company finances its assets by combining liabilities and equity (Gul & Cho, 2019). Listed companies possess the basic characteristics whereby different shareholders, forming the company's ownership structure, own equity capital. Ross (1977) explains that, when a company issues new debt, it becomes a sign or signal to shareholders and investors about the company's prospects in the future. This signaling theory arises because of asymmetric information problems caused by asymmetric conditions of information existing from time to time; companies must maintain loan reserve capacity by keeping loans low. Myers and Majluf (1984) also formulated a signaling model, which was a combination of investment decisions and funding decisions.

The effect of capital structure influencing corporate performance has been proven empirically (Ikapel & Kajirwa, 2017; Khan et al., 2013; Khanam et al., 2014; Mwangi et al., 2014; Sumani, 2015). Capital structure has a significant negative effect on financial performance. It contrasts with research (Detthamrong et al., 2017; Modigliani & Miller, 1963) showing that capital structure has a significant positive effect on financial performance. Vithessonthi and Tongurai (2015) show that capital structure has a significant negative effect on corporate performance. However, internationally-oriented companies show that capital structure has a significant positive effect on corporate performance.

H4. Capital Structure influences Corporate Performance.

2.5. Liquidity Policy and Corporate Performance

According to Brealey et al. (2007), liquidity is the ability to sell an asset to get cash in a short time, especially to settle large and unexpected bills. Companies certainly also have assets with different degrees of liquidity, so corporate liquidity policy becomes very important in each company. Takon and Ogakwu (2013) show that liquidity has a significant positive effect on return on assets. Durrah et al. (2016) also showed a significant positive effect of all liquidity ratios (current ratio, quick ratio, defensive interval ratio) on gross profit margin, operating profit margins, net profit margins, operating cash flow margins, and return on assets. Samo and Murad (2019) show liquidity (current ratio), significantly positive effect on a firm's profitability (return on assets, and return on equity). Bagchi and Chakrabarti (2014) show that liquidity management has a significant negative effect on profitability (return on investment).

H5. Liquidity Policy influences Corporate Performance.

2.6. Capital Structure and Liquidity Policy

Sarlija and Hanc (2012) show that liquidity ratios which are proxied by current ratio, quick ratio, and cash ratio have a significant adverse effect on leverage ratios, which is proxied by debt ratio, debt to equity ratio and debt factor. However, the cash ratio does not have a significant effect of leveraging proxied by a long term debt ratio. Khanqah and Ahmadnia (2013) also explained that liquidity, which was proxied by cash flow to total assets ratio, had a significant negative effect on capital structure. However, liquidity, which was proxied by cash flow to net income ratio and cash flow to equity ratio, had a significant positive effect on capital structure. Furthermore, Takon and Ogakwu (2013) explained that liquidity is the primary financial indicator in measuring whether companies can fulfill their commitments for payment of short-term, long-term debt and, total debt ratio. Bukair (2019) shows that bank size, liquidity, and corporate age are positively correlated to the leverage ratio, supporting the trade-off theory.

Some empirical studies indicate a reciprocal relationship between capital structure and corporate liquidity policy and significant research results. Burksaitiene and Draugele (2018) show that capital structure has a significant negative effect on liquidity, meaning that a high company equity will reduce liquidity risk, conversely, high debt capital will increase liquidity risk. Dasgupta et al. (2011) state that companies with high levels of debt make cash flow negative and make cash flow more sensitive. In other words, the unfavorable capital structure can increase the level of sensitivity to cash flow. Dasgupta et al. (2011) state that there is a positive correlation between capital structure components and cash flow shock. According to Darabi et al. (2012), cash flow

shock is the effect of changes in operating cash, which leads to cash holding. In contrast, research conducted by Darabi et al. (2012) shows is no correlation or effect between capital structure and cash flow sensitivity.

H6. Capital Structure affects Liquidity Policy

H7. Liquidity Policy affects the Capital Structure.

3. Methodology

This study aims to examine and explain the effect of exogenous variables on endogenous variables, so that the type of research used is explanatory research. Exogenous variables are corporate governance, while endogenous variables include capital structure, corporate liquidity policy, and corporate performance. The sampling method using Judgment Sampling identified as many as 109 companies, as well as research data on manufacturing companies listing on the Indonesia Stock Exchange in 2010-2019. Data analysis uses the Partial Least Square Warp (WarpPLS) to investigate the variables in the study by testing the hypothesis by performed t-test.

4. Results and Discussion

4.1. Model Fit and Quality Indices Model WarpPLS

There are ten measurements of Model Fit and Quality Indices in the WarpPLS analysis to measure the quality of structural models (Solimun et al., 2017) (see Table 1).

4.2. Indicator Weights

Indicator weights are used to determine the strength of the indicator as a measure of latent variables. Indicators with large weights indicate that the indicator has a strong ability to reflect latent variables. Corporate governance as an exogenous variable has three indicators, namely, independent commissioners, management ownership, and public ownership. Independent Commissioners weight 0.317, Management Ownership, has a weight of 0.255, and Public Ownership has a weight of 0.440. All indicators of corporate governance have p-values less than 0.001. Thus, public ownership indicators have a stronger ability to form corporate governance variables compared to the other two indicators.

The capital structure as the first mediating variable has two indicators, namely, Debt-to-Asset Ratio (DAR) and Debt-to-Equity Ratio (DER). The DAR indicator weight is 0.407 with p-value <0.001 and DER weights 0.613 with p-value <0.001. The debt-equity ratio (DER) indicator has a stronger and more significant ability to shape the capital structure variable. Liquidity policy as the second mediating variable has three indicators, namely, cash holding, liquid

Table 1: Model Fit and Quality Indices

No	Model Fit and Quality Indices	Fit Criteria	Value	Result
1	Average Path Coefficient (APC)	$P < 0.05$	0.282; $P < 0.001$	Good
2	Average R-Squared (ARS)	$P < 0.05$	0.361; $P < 0.001$	Good
3	Average Adjusted R-Squared	$P < 0.05$	0.345; $P < 0.001$	Good
4	Average Block VIF (AVIF)	Acceptable if < 5 , Ideally < 3.3	2.047	Ideal
5	Average Full Collinearity VIF	Acceptable if < 5 , Ideally < 3.3	2.310	Ideal
6	Tenenhaus GoF (GoF)	Small > 0.1 , Medium > 0.25 , Large > 0.36	0.527	Large
7	Symspson's Paradox Ratio (SPR)	Acceptable if > 0.7 , Ideally 1	0.854	Good
8	R-Squared Contribution Ratio	Acceptable if > 0.9 , Ideally 1	0.901	Good
9	Statistical Suppression Ratio (SSR)	Acceptable if > 0.7	0.925	Good
10	Nonlinear Bivariate Causality Direction Ratio (NLBCDR)	Acceptable if > 0.7	0.832	Good

Table 2: Hypothesis Testing on the Direct Effect of WarpPLS Analysis

No.	Influence Between Variables	Coefficients	p-value	Description
1	Corporate Governance → Capital Structure	0.279	0.015	Significance
2	Corporate Governance → Liquidity Policy	-0.182	0.004	Significance
3	Corporate Governance → Corporate Performance	0.363	0.001	Significance
4	Capital Structure → Corporate Performance	-0.216	0.012	Significance
5	Liquidity Policy → Corporate Performance	0.081	0.110	Not Significance
6	Capital Structure → Liquidity Policy	0.127	0.033	Significance
7	Liquidity Policy → Capital Structure	0.377	0.011	Significance

assets, and cash ratio. Cash holding indicators have a stronger ability to form variable liquidity policies. It is evidenced by the indicator weight of 0.509 with p-value < 0.001 . Corporate performance variables as endogenous variables have three indicators, namely, ROA, ROE and Tobin's Q. Tobin's Q indicators have a stronger ability to form corporate performance variables with an indicator weight of 0.492 and p-value 0.001. The results of testing the direct effect hypothesis with WarpPLS are shown in Table 2.

Table 2 shows that all hypotheses were proven to be significant, except for the fifth hypothesis, which was not proven; that is, the corporate liquid policy had a significant effect on corporate performance.

4.3. Discussion

Hypothesis testing results indicate that corporate governance has a significant positive effect on capital

structure. The meaning of the results of this study confirms that corporate governance can play a role in shaping the effectiveness of capital structure management by utilizing supervision, budget discipline, and encouraging efficiency in corporate management. The results of this study support the previous research (Fama & Jensen, 1983; Jensen & Meckling, 1976; Liao et al., 2015; Masnoon & Rauf, 2014; Myers & Majluf, 1984; Shyu, 2013; Siromi & Chandrapala, 2017; Su, 2010; Sun et al., 2016), but do not support the research by Motjaba et al. (2014).

Hypothesis testing results indicate that corporate governance has a significant negative effect on corporate liquidity policy. These results prove that the ability of companies to make policies about liquidity will be determined by how well and effective the role of corporate governance is. The results of this study support the research by Papaioannou et al. (1992), but it contradicts other research (Bokpin et al., 2011; Luo & Hachiya, 2005).

The results of the study show that corporate governance has a significant positive effect on corporate performance. This condition confirms that if corporate governance, both in terms of composition and size as well as competencies, are arranged appropriately, corporate governance will play the major role in improving company performance. It is due to the effective functioning of the supervision, which will reduce the occurrence of agency costs and other transaction costs. The results of this study support the previous research (Bhatt & Bhatt, 2014; Mardnly et al., 2018; Ofoeda, 2017; Orazalin et al., 2016; Saidat et al., 2019). However, Saidat et al. (2019) also found that corporate governance had no significant effect on the performance of non-family firms.

The results of testing the hypothesis show that capital structure has a significant negative effect on corporate performance. The results of this test confirm that companies that are mostly funded from debt will have an impact on decreasing corporate performance. This is due to an increase in financial risk, a decrease in shareholders' income, which lead to agency costs. The results of this study support the previous research (Ikapel & Kajirwa, 2017; Khan et al., 2013; Khanam et al., 2014; Mwangi et al., 2014; Samo & Murad, 2019; Vithessonthi & Tongurai, 2015), but do not support the research results by Chang et al. (2010); Detthamrong et al. (2017); Modigliani and Miller (1963).

The results of hypothesis testing show that corporate liquidity policy has no significant effect on corporate performance. This phenomenon explains that the high corporate liquidity policy (cash holding, liquid assets, and cash ratio) does not have a direct impact on improving the company's operations. The corporate liquidity policy is not directly related to the addition of working capital or investment, but instead is focused on activities to reduce the cost of capital, especially in meeting unexpected funding needs and obligations that will soon be due. High liquidity may be an indication of agency problems due to differences in interests between principals and agents (Jensen, 1986). Managers prefer the existence of substantial cash because this form of liquid assets is the easiest to use by managers for their well-being (Myers & Rajan, 1998). It means that the high liquidity of a company is not merely to improve corporate performance, but there is a tendency for the welfare of managers themselves. The results of this study do not support the research results (Bagchi & Chakrabarti, 2014; Samo & Murad, 2019; Takon & Ogakwu, 2013).

Hypothesis testing that capital structure has a significant positive effect on corporate liquidity policy. Companies that have high levels of debt will undoubtedly have an impact on the high cost of capital, and ultimately will reduce the company's profitability. Declining profitability can result in a decrease in cash flow, so the company will use cash holding, liquid assets, and cash ratio to cover the cost of capital. Thus,

the risk of bankruptcy experienced by the company will be higher, and the company must prepare substantial funds to anticipate the bankruptcy earlier. The results of this study support the study by Dasgupta et al. (2011), but it contradicts the research by Burksaitiene and Draugele (2018) and Darabi et al. (2012).

The results of the study show that corporate liquidity policy has a significant positive effect on capital structure. Manufacturing companies that have excellent corporate liquidity policy are formed by proper capital structure management and the capital structure with a proportion of debt that is balanced with its capital. Thus, if the company's debt is high, of course, liquidity policy in the form of cash holding, liquid assets, and cash ratio will also be high. It is because companies must provide sufficient cash balances to cover capital costs, anticipate financial risks, and other unexpected needs. The results of this study support the research by Bukair (2019); Khanqah and Ahmadnia (2013); Sarlija and Hanc (2012). Nevertheless, it does not support research by Bagchi and Chakrabarti (2014).

5. Conclusion

The results of the study state that corporate governance has a significant positive effect on the capital structure, but a significant negative effect on corporate liquidity policy and a significant positive effect on corporate performance. Capital structure has a significant negative effect on corporate performance, and liquidity policy is not significantly correlated with corporate performance. Capital structure has a significant positive effect on corporate liquidity policy, and liquidity policy has a significant positive effect on capital structure. Future studies should include corporate governance indicator variables, namely, institutional ownership, the board of directors, domestic ownership, ownership concentration, auditors' opinions, ultimate ownership, state ownership, the role of quality, board meetings, remuneration committees, and several meetings held.

This research is expected to provide input for companies managing corporate governance by paying more attention to capital structure and corporate liquidity policy in optimizing corporate performance, to improve the welfare of shareholders and stakeholders. Besides, companies must also be aware that investors will conduct an assessment of the application of corporate governance in the feasibility analysis of investment decisions. Furthermore, it can enrich the conceptual discussion and consolidate the study of corporate governance, through agency theory developed by Jensen and Meckling (1976) and Fama and Jensen (1983), transaction costs introduced by Williamson (1979, 1981, 1984), as well as financial models (Shleifer & Vishny, 2012), and signaling theory (Ross, 1977).

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