ISSN: 2456-7760

THE ROLE OF INDEPENDENT DIRECTORS IN TRADING COMPANIES IN INDONESIA

Metha Wahyu Rahmatika
Magister Akuntansi, Universitas Sebelas Maret
Payamta
Magister Akuntansi, Universitas Sebelas Maret

Abstract

This study aims to analyze the role of independent directors on the financial performance of trading companies in Indonesia with two-tier board system. The company's financial performance as the dependent variable is measured using Piotroski Fscore. The independent variable of this study is independent directors (DIND) and the control variables are board size (UDD), external pressure (LEV), and sales growth (GROWTH). Data samples were obtained from the official IDX website using a purposive sampling method. Data is processed using descriptive analysis and panel data regression. The results of panel data regression show that independent directors (DIND), board size (UDD), and sales growth (GROWTH) have a positive effect on the company's financial performance, while external pressure (LEV) does not affect the company's financial performance.

Keywords: independent director, financial performance, two-tier boad system

Introduction

Indonesia uses a two-tier board system or the separation of supervisory and executive functions (UU No.40, 2007). The composition of the board of directors is part of corporate governance that has full authority and responsibility for the management of the company for the benefit of the company in accordance with the aims and objectives of the company and representing the company (POJK No. 33,2014). The board of directors serves to determine the resource strategy and direction of company policy, both short and long term (Sukandar, 2014). The board of directors functions to ensure that the company has been executed properly so that it can achieve the company's goals. In addition, the board of directors also serves to limit management behavior that is selfish (Eisenhardt, 1989). Information asymmetry (management knows more about the condition of the company than the principal) can make management feel that they own the company and ignore the company's goals. Management can make debt on behalf of the company but for personal interests, this has an impact on increasing leverage and decreasing company liquidity which will ultimately worsen the company's financial performance. The effectiveness of the role of the board of directors is very dependent on the ability of board members to work collectively; this is the essence of the notion of "council" as a group in the form of teamwork (Lukviarman, 2016). Based on this statement, more and more parties responsible for managing a company have the potential to reduce management actions in their own benefit so that the company's financial performance can increase. This is supported by research by Abor et al.

Vol. 3, No. 02; 2019

ISSN: 2456-7760

(2007) and Darko et al. (2016) which states that companies with more directors will improve the company's financial performance.

It has been explained previously that the board of directors serves to determine the resource strategy and direction of company policy, both short and long term. The board of directors is an important mechanism in limiting the manager's self-behavior or management's actions to their own advantage, but in reality the board of directors does not always protect the interests of shareholders and does not limit management's actions in its own favor (Patton & Baker, 1997; and Davis, 1991). The number of members of the board of directors must be more than one person to prevent individual actions from the board of directors who want to benefit themselves at the expense of company value. In fact, a large number of directors may not necessarily prevent actions that could harm the company. The existence of kinship relations or affiliated relations between members of the board of directors can lead to actions that can harm the company in groups (they can formulate or formulate a policy that benefits the group but harms the company), therefore independent directors or unaffiliated directors are needed as independent parties to reduce the potential for action to be detrimental to the company by a group of other members of the board of directors. This statement is supported by SE-00001 / BEI / 02-2014 attachment 1 concerning Regulation Number I-A that requires prospective companies to be listed on the main board to have an independent director of at least one person. Johnson et al. (1996) state that a company dominated by an independent director will share potential management actions that benefit themselves. Lefort et al. (2008) stated that more independent directors could improve the company's financial performance.

The pros and cons of the existence of independent directors in Indonesia are a problem. Some researchers disagree with regulations that require companies that register shares on the main board to have at least one independent director. They assume that the existence of independent directors does not fully have an impact on improving company performance, because the independence of board members has been represented by independent commissioners (www.cnbcindonesia.com). Financial statements represent the financial performance of a company. Financial reports need to be processed so that they are easily understood by users of financial statements. Profitability shows the company's ability to benefit from capital management (Harjito & Martono, 2011). Profitability ratios can be used to measure a company's financial performance, but the assessment of a company's financial performance based on profitability alone cannot represent the company's financial performance as a whole. Activity ratios and liquidity ratios are needed as other assessments that must be considered in measuring the company's financial performance (Groppelli & Nikbakht, 2000).

Piotroski Fscore is one method of assessing financial performance using nine variables from financial statements that can be categorized into Financial performance signals: Profitability, Financial performance signals: Operating efficiency and Financial performance signals: leverage, liquidity, and Source of funds (Piotroski, 2000). This valuation method is used to separate solid companies from companies that have low price-to-book value and are underestimated by investors because they are considered to have the potential to experience financial difficulties.

The method has a score to determine which companies are in the excellent to very bad category. Based on the literature and assumptions of previous research, the researcher aims to examine the role of independent directors in improving the financial performance of trading companies registered in Indonesia in 2014-2017.

H: Independent directors have a positive effect on the company's financial performance

Method

This research is a secondary research, the research data taken from financial reports and annual reports of wholesale and retail trade companies listed on the IDX through the official website (www.Idx.co.id). Based on Indonesia Stock Exchange Fact Book, Wholesale and retail trade is a sub-sector of the trade, service and investment sectors. The use of the trade sector is the object of research, because the trade sector is a major driver of the country's economy (UU No.7, 2014). The population in this study is a trading company registered on the Stock Exchange for 4 years (2014-2017). Samples were selected by purposive sampling, with the following criteria:

1. Trading companies are listed on the IDX for 4 years (2014-2017).

2. Having complete data.

3. Using the rupiah currency consistently.

A. Dependent variable

The company's financial performance is the dependent variable or variable that is influenced in this study. Measurements were made using Piotroski Fscore. Piotroski Fscore is one of the tools used to measure financial performance in three signals. Piotroski (2000) describes the three signals as follows:

1. Financial performance signals: Profitability

   Current profitability and the realization of positive cash flows show capacity about the company's ability to generate funds internally through operating activities. This signal measures financial performance with 4 variables, namely:

   a. Return On Assets (ROA)

      ROA = Net profit / total assets. If the ROA value is more than 0 (zero) then F1 = 1, if otherwise F1 = 0.

   b. ΔROA

      ΔROA = ROA t - ROA (t-1). If ΔROA is more than 0 (zero) then F2 = 1, if otherwise t F2 = 0.

   c. Cash Flow from Operations (CFO)

Vol. 3, No. 02; 2019

ISSN: 2456-7760

CFO = Operating cash flow / total assets. If CFO is greater than 0 (zero) then F3=1, if otherwise F3 = 0.

d. ACCRUAL

ACCRUAL = ROA - operating cash flow. In this case the operating cash flow is expected to be greater than ROA, so that F4 = 1 if the ACCRUAL value is less than 0, if otherwise F4 = 0.

2. Financial performance signals: Operating efficiency

This signal reflects the key constructs underlying the decomposition of asset returns and is designed to measure changes in the efficiency of a company's operations. Operational efficiency is the ability of companies to convert company resources into better income than their competitors (Cho et al., 2015). This signal measures financial performance with 2 variables, namely:

a. Change in gross margin (ΔMARGIN)

ΔMARGIN = Gross profit (t) - gross profit (t-1). If ΔMARGIN is more than 0 (zero) then F5 = 1, if otherwise F5 = 0.

b. Asset turnover (ΔTURN)

ΔTURN = (Sales / total assets) t - (sales / total assets) t-1. If ΔTURN is greater than 0 (zero) then F6 = 1, if otherwise F6 = 0.

3. Financial performance signals: leverage, liquidity, and Source of funds

This financial signal is designed to measure changes in the capital structure and the ability of a company to fulfill its future debt repayment obligations. Zainudin & Hashim (2016) argues that the signal shows the company's ability to generate income from loans used for company operations. Piotroski (2000) assumes that increasing leverage, deteriorating liquidity, or using external financing is a bad signal for the company's financial performance. Because the higher the responsibility for the repayment of the loan will make the company's financial burden bigger even though funding from the loan is used for the company's operations. This signal consists of three variables, namely:

a. ΔLEVER

ΔLEVER = (total debt / total assets) t - (total debt / total assets) t-1. If ΔLEVER is less than 0 (zero) then F7 = 1, if otherwise F7 = 0.

b. LIQUID

LIQUID = (current assets / current liabilities) t - (current assets / current liabilities) t-1. If ILIQUID is more than 0 (zero) then F8 = 1, if otherwise F8 = 0

c. EQ_OFFER

F9 = 1 if the company does not issue new share capital, if the opposite is F9 = 0

Based on the explanation above, the Fscore formula is:

F-SCORE = $\sum_{1}^{9} F$ or total from F1 to F9

Piotroski (2000) classifies companies in three categories, namely:

1. High Performance, companies that have the best performance have a total of FSCORE 9 (nine) or 8 (eight) values.
2. Low Performance, the company with the lowest performance has a total value of FSCORE 0 (zero) or 1 (one).
3. Grey area, companies that have a total FSCORE value in the range of 2 (two) to 7 (seven). At this score, company performance is not stated as good or bad

B. Independent variable

An independent board of directors or an unaffiliated board of directors is a board of directors that has no affiliation with the major shareholders, members of the board of directors and board of commissioners, and does not serve as a board of directors or board of commissioners in other companies or is not an insider from another company , 2014). Lukviarman (2016) states that the active role of independent directors in business processes is needed to improve company performance. The independent board of directors is measured by the number of independent directors in the company.

C. Control Variables

The control variables in this study consisted of board size, external pressure, and sales growth. Based on the Financial Services Authority Regulation No. 33 of 2014, the board of directors is a corporate organ that is authorized and responsible for managing a company in accordance with the company's objectives. The role of board members in making strategies, services and supervision is an important component in a company (Zahra & Pearce, 1989). The size of the board of directors is measured based on the number of board of directors in the company. External pressure can have a positive or negative impact on the company's financial performance depending on the economic conditions of a company (Vengesai & Kwenda, 2018). External pressure in this study was measured using leverage. The measurement represents pressure from outsiders in terms of corporate finance. Sales growth (GROWTH) shows the company's ability to

get profits every period and increased sales growth from the company is a good signal for investors.

Table 1 Measurement of Variables

	Measurement	explanation
Dependent Variable:		Fscore = Company financial performance
Fscore	$\sum_1^9 F$ atau or total from F1 to F9	DIND = independent directors
Independent Variables:		UDD = board of directors
DIND	Number of independent directors	LEV = External pressure
Control Variables**:**		GROWTH = Sales growth
UDD	Number of directors	
LEV	$\frac{\text{Total debt}}{\text{Total Asset}}$	
GOWTH	$\frac{Sales_t - Sales_{(t-1)}}{Sales_t}$	

The study was tested using descriptive statistical analysis and panel data regression analysis. The regression equation for testing the hypothesis in this study is:

F-Score = α + ß1DIND + ß2UDD + ß3LEV + ß4GROWTH + ε

Results and Discussion

Based on the results of purposive sampling, a sample of 128 companies was obtained from a total population of 152 companies. the table below is the result of descriptive statistics.

Table 2 Descriptive Statistics

	N	Minimum	Maximum	Mean	Std. Deviation
DIND	128	1.00	2.00	-	0.24301
UDD	128	1.00	7.00	-	1.73232
LEV	128	0.01	1.47	0,4772	0.27319
GROWTH	128	-1.00	4.63	0,1322	0.68992
FSCORE	128	1.00	9.00	5,2812	1.80086

Data Results

Based on Table 2 the financial performance of trading companies in Indonesia during 2014 to 2017 were measured using Piotroski F-score on average in the grey area with an average value of 5.2812. The company is categorized in the grey area if the Fscore value is in the range of 2 (two) to 7 (seven). The minimum value of FSCORE or the financial performance of wholesale and retail trade companies in Indonesia for four years of observation is 1 (one), the value is included in the low performance criteria (Piotroski, 2000). Of the 128 samples, there is only one company included in the low performance category, which is a company with an ITTG in 2016. But in the following year, in 2017 the company can improve its financial performance.

Piotroski (2000) states that companies can be said to be in high performance conditions when they have an FSCORE value of 8 (eight) or 9 (nine). Based on Table 2, companies that have a FSCORE value of 9 (nine) or high performance, namely companies with TGKA in 2014, WAPO in 2014, CSAP in 2014, ERAA in 2016, and RANC in 2016, While companies with FSCORE 8 (eight) are companies with the code of TGKA in 2017, HERO in 2016, MAPI in 2015, SONA in 2014, and SONA in 2015. Total wholesale and retail trade companies that enter high performance criteria for four years of observation amount to 10 out of a total of 128 samples.

Independent director variable (DIND) has a minimum value of 1 and a maximum value of 2. Based on these data, it can be concluded that wholesale and retail companies in Indonesia have complied with the applicable provisions. The board size variable (UDD) has a minimum value of 1 person and a maximum of 7 people, this number meets the optimal number for directors in Indonesia. Jensen (1993) and Lipton & Lorsch (1992) state that a large number of boards is less effective in company performance, because it can complicate coordination and decision making (the optimal size of the board is 7-8 people). the variable that has the largest standard deviation is FSCORE or the company's financial performance (1,80086) and the smallest standard deviation is DIND or independent director (0,24301). This means that the company's financial performance has the largest data distribution, while the independent director has the smallest data distribution.

Table 3 Results of Panel Data Regression

Variabel	Koefisien	Prob.
(Constant)	2.385387	0.0083
DIND	1.738125	0.0086*
UDD	0.322478	0.0006*
LEV	-0.170735	0.7616
GROWTH	0.490898	0.0295*
R Square	0.133165	
Adjusted R Square	0.104976	
F	4.723891	
Sig	0.001401	

(*) α= 5%

Based on Table 3 the value of Adjusted R Square is 0.104976 or 10.5%, this indicates that 10.5% of the independent variables explain the dependent variable, and 89.5% can be explained by other variables outside the research model. The F test shows that the DIND, UDD, LEV, and GROWTH variables together influence the FSCORE dependent variable with a probability of 0.0014 or 0.14%.

The t-test results show that independent directors (DIND) have a coefficient of 1.738125 and a probability level of 0.86%, so it can be concluded that independent directors have a positive influence on the company's financial performance. the size of the board of directors (UDD) also shows the same thing, with a coefficient of 0.322478 and a probability level of 0.06%. This shows that the size of the board of directors has a positive effect on the company's financial performance. These results indicate that independent directors have a role to play in improving the company's financial performance. The sales growth control variable (GROWTH) has a positive effect on improving financial performance, while external pressure (LEV) does not affect the company's financial performance.

Based on Table 3, the panel data regression equation model is as follows:

$$\mathbf{Fscore = 2.385387 + 1.738125DIND + 0.322478UDD + 0.490898GROWTH + \varepsilon}$$

Conclusion

This study aims to analyze the influence of independent directors on the financial performance of trading companies listed on the Stock Exchange in 2014-2017. The results showed that the prediction model developed in this study was fit to be used as a research model. The conclusions show that independent directors have a positive effect on the financial performance of wholesale and retail trade companies in Indonesia. This shows that the existence of independent directors has a role in improving the financial performance of trading companies in Indonesia during the year of observation. The researcher assumes that the company still needs an independent director in corporate governance. the existence of an independent director is needed to dampen the actions of the manager's self-behavior by other members of the board of directors because of an affiliate relationship (family).

The results also show that the size of the board of directors and sales growth has a positive effect on the company's financial performance, while external pressure does not affect the company's financial performance. Based on the results of a study that shows that independent directors have a role in improving the company's financial performance, the practical implications of this research are to consider the company to have at least one independent director to support effective corporate governance. The limitation in this study is that the study sample consisted only of wholesale and retail trade companies listed on the IDX, so that further research can develop samples using registered and unregistered trading companies to be able to generalize research results.

Bibliography

Abor, J., dan Biekpe, N. (2007). Corporate governance, ownership structure and performance of SMEs in Ghana: implications for financing opportunities. *The International Journal of Business in Society*, *7*(3), 288–300. https://doi.org/10.1108/147207007 10756562.

Cho, M., Lee, H., & Park, H. (2015). Characteristics of statutory internal auditors and operating efficiency. *Managerial Auditing Journal*, *30*(4/5), 456–481. https://doi.org/10.1108/MAJ-05-2014-1037.

Darko, J., Aribi, Z. A., dan Uzonwanne, G. C. (2016). Corporate governance: the impact of director and board structure, ownership structure and corporate control on the performance of listed companies on the Ghana stock exchange. Corporate Governance (Bingley) 16(2), 259–277. https://doi.org/10.1108/CG-11-2014-0133.

Davis, G.F. (1991). Agents without Principles? The Spread of the Poison Pill through the Intercorporate Network. Administrative Science Quarterly 36(4), 583-613.

Eisenhardt, K.M. (1989). Agency Theory: an Assessment and Review. Academy of Management Review 14(1), 57-74.

Harjito, Agus dan Martono. (2011). Manajemen Keuangan, Edisi Kedua, Cetakan Pertama, Penerbit EKONISIA, Yogyakarta.

Jensen, M. (1993). The Modern Industrial Revolution, Exit, and The Failure of Internal Control System. *Journal of Finance* 48, 831-880.

Lipton, M.,dan J. Lorsch. (1992). A Modest Proposal for Improved Corporate Governance. *Business Lawyer* 48, 59-77.

Johnson, R.A., Daily, C.M. dan Ell strand, A.E. (1996). Boards of Directors: A Review and Research Agenda. Journal of Management 22(2), 409-438.

Lefort, F., dan Urzúa, F. (2008). Board independence , firm performance and ownership concentration : Evidence from Chile *61*, 615–622.

Lukviarman, N. (2016). *Corporate Governance: Menuju Penguatan Konseptual dan Implementasi di Indonesia*. Jakarta: Era Adicitra Intermedia.

UU No.40. (2007). Undang-Undang Republik Indonesia Nomor 40 Tahun 2007 Tentang Perseroan Terbatas.

UU No.7. (2014). Undang- Undang Nomor 7 Tahun 2014 tentang Perdagangan.

Patton, A dan Baker J.C. (1987). Why Won't Directors Rock the Boat?. Havard Business Review, 65(6), 10-18.

Peraturan OJK No.33. (2014). Direksi dan Dewan Komisaris Emiten atau Perusahaan Publik. *Nomor 33/Pojk.04/2014.*

Piotroski, J. D. (2000). Value Investing: The Use of Historical Financial Statement Information to Separate Winners from Losers. *Journal of Accounting Research*, *38*, 1–41.

Sukandar, Panky Pradana dan Rahardja. (2014). Pengaruh Ukuran Dewan Direksi dan Dewan Komisaris serta Ukuran Perusahaan terhadap Kinerja Keuangan Perusahaan. DIPONEGORO JOURNAL OF ACCOUNTING. ISSN (3) 1-7 http://ejournal-s1.undip.ac.id/index.php/accounting ISSN (Online): 2337-3806.

Surat Edaran PT Bursa Efek Indonesia No. SE-00001/BEI/02-2014.

Vengesai, E., & Kwenda, F. (2018). The impact of leverage on discretionary investment: African evidence. *African Journal of Economic and Management Studies*. https://doi.org/https://doi.org/10.1108/AJEMS-06-2017-0145.

Zahra, S. A., & Pearce, J. A. (1989). Boards of Directors and Corporate Financial Performance: A Review and Integrative Model. *Journal of Management*, *15*(2), 291–334. https://doi.org/10.1177/014920638901500208.

Zainudin, E. F., & Hashim, H. A. (2016). Detecting fraudulent financial reporting using financial ratio. *Journal of Financial Reporting and Accounting*, *14*(2), 266–278. https://doi.org/10.1108/JFRA-05-2015-0053.

https://www.cnbcindonesia.com/market/20181226161205-17-48036/emiten-tak-lagi-wajib-miliki-direktur-independen-kenapa.www.idx.co.id