

MARKET REACTION BASED ON CORPORATE GOVERNANCE STRUCTURE

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ABSTRACT

Problems can be identified within agency by understanding the distribution of power among parties in the organization. Distribution of power within organization determines the corporate governance structure owned by public trade companies. This study is conducted to predict market reaction based on corporate governance structure (institutional ownership, independent commissioners, and audit committees) of strong public trade companies in Indonesia, and to give an idea how the application of corporate governance in the current economy. The population of this study is the go public-companies in Indonesia of 2007-2011. The samples are obtained with purposive sampling method due to the following criteria: Firstly, the go public-companies excluding banks and other financial institutions; Secondly the companies having only one policy of Seasoned Equity Offerings (SEO) without applying other policies (stock split, option conversion, bonus shares, dividend shares, stock dividends, etc.) during the observational period from 2007 until 2011. Data analysis is conducted with multiple linear regression analysis using SPSS version 19. The results of this study indicate that the application of corporate governance structure (especially the independent commissioner and audit committee) will result in positive market reaction, leading to good financial accounting and corporate governance further researches to analyze other variables that influence market reaction overcoming problems of agency and realized good corporate governance. For company regulator, this study has the implications on views related to the effectiveness of regulatory enforcement. For company, this research has implications to encourage companies comply the regulations imposed by regulator that good corporate governance will be well established.

Keywords: Corporate Governance Structure, Market Reaction, Go Public-Company.

INTRODUCTION

As the problems appear, such as requiring additional funds for operations, investment or paying the maturing debts, stock returns and capital structures, public companies may perform additional equity offerings regardless to the equity offered to public through *initial public offerings* called *Seasoned Equity Offerings* (SEO). Megginson (1997) defines SEO as additional equity offering (stock) committed by the listed companies on stock market regardless to the equity (stock) initially offered to the public through initial public offerings.

Asymmetric Information may also occur in SEO offering as the Initial Public Offering (Guo and Mech, 2000). The presence of asymmetric information is probably caused by the imbalance information due to the unequal distribution of information between *corporate insiders* and *outsider investors* although prospective investors have adequate information upon SEO committing companies (Myers and Majluf, 1984). Thus, this asymmetric information results in two problems generated from the difficulty of outside investors to monitor and control people's actions in the company, including *moral hazard*, problems arisen when agents (corporate insiders) do not apply what has been agreed in the employment contract, (b) *adverse selection*, a situation in which principal (outsider investors) cannot consider whether the decision made by the agent (corporate insiders) is in fact based on actual information, or merely as the negligence of duties (Sabeni, 2005). According to agency theory, to overcome the problem of unharmonious interests between *principal* and *agent* can be committed through corporate governance.

Post-SEO underperformance is also possible to occur that furthermore it has become the standard pattern (Shivakumar, 2000). Trail&Vos (2001) explain that this phenomena use the concept of *agency theory* and *windows of opportunity*. In the concept of *agency theory*, asymmetric information encourages and motivates managers to act opportunistically, such as manipulating the performance information published to increase the offered stock positively responded by the market aiming to improve the *fully subscribed issues* (Rangan, 1998; Teoh et al., 1998). Shivakumar (2000) also indicates that manager has already committed *overstate* upon *earnings* before SEO announcement. However, the manipulation known as earnings management is not tenable in long term and lead to post-offering underperformance (Rangan, 1998). In line with the concept of *agency theory*, Trail&Vos (2001) also describes underperformance with the concept of *windows of opportunity*, a concept that describes the manager opportunistic attitudes by issuing additional equity after realizing that market assessed the company too high (overvalued). Yet, assessment cannot be maintained in long term since market will make corrections to their "mistakes", resulting in the company's stock price significant drop. While Shivakumar (2000) concludes that this post-offering underperformance is caused by the "inappropriate" earnings measurement (*overstate*). This condition influences the interpretation of investors and leads to over-optimism in predicting company's future earnings.

Research on SEO has been conducted, including by Candy (2002) with the samples of all SEO committing companies, concludes that the company experienced underperformance operation over three years after offering. The study assumes that

underperformance after offering is due to the manipulation of performance committed by managers immediately before offering. However, the allegation has not been specifically proven. Thus, by these reasons which are in line with the study conducted by Alderson and Betker (1997) and Trail&Vos (2001) will try to examine whether the post-SEO underperformance is caused by the manager opportunistic attitude due to agency problems and the windows of opportunity.

SEO phenomena is exceptionally interesting to be studied in depth since SEO announcement committed by the company has always been followed by *underperformance*. This underperformance is actually reasonable as companies usually manipulate performance before and while offering. This manipulation is committed in order that market will positively respond to the offers. This study will examine how SEO committing companies own strong *corporate governance* that possibly reduce *adverse selection* and agency problems (Huang and Thompkins, 2009) that SEO is expected to increase and the performance will improve.

THEORETICAL FRAMEWORK AND HYPOTHESIS DEVELOPMENT

Institutional Ownership Influence to Market Reaction

Institutional ownership is the percentage of rights to vote held by the institutions (Beiner et al., 2003). Boediono (2005) states that the ownership concentrated institutions have considerable stock reflecting power and ability to intervene in the operation of company and to control the process of financial statement preparation. The company intervention leads managers to act fulfilling their own interests or desires which is frequently referred to as *moral hazard*.

Institutional ownership can also be interpreted as ownership held by institutions with the equity of 5% or more of the initial capital in the related year (Helen Short et al., 2002 in Jama'an 2008). This characteristic is commonly found in companies listed in Indonesia Stock Exchange (Husnan, 2001 and Gunarsih, 2003).

Beiner et al., (2003) and Shleifer and Vishny (1997) find that investors will positively react in the event that company has one or larger shareholders, meaning that positive reaction of investors can predict market reaction which is also positive that the financial and stock performance of companies can increase. These results are in line with the findings of McConell and Servaes (1990), Nesbitt (1994), Smith (1996), Del Guercio and Hawkins (1999), Partner (2002) Hartzell and Starks (2003), Koh (2003) in Cornett et al., (2006) and Pratt and Mas'ud (2003) who conclude that the company supervision and institutional investors may encourage managers to focus their attention more on the company performance that market will positively react to these conditions.

H1: Institutional Ownership has positive influence to market reaction

Independent Commissioner Influence to Market Reaction

Fama and Jensen (1983) states that *non-executive directors* (independent commissioners) can act as mediator in disputes between internal managers, supervise the management policy, and provide some suggestions to management, so it is not mistaken if independent commissioner is the best position to executing the function of *monitoring* or supervising to generate good corporate governance. Therefore, Indonesia Stock Exchange Inc. (ISX) has required the presence of independent commissioner in the management of issuer to represent the minority shareholders. The ISX has regulated on the ratio of independent commissioners should be proportionally equal to the number of shares held by non-controlling shareholders with conditions that the number of independent commissioners are at least 30% (thirty percent) of the total number. (Decree of Indonesia Stock Exchange Inc Management. No. KEP-315/BEJ/062000).

Beasley (2004) , and Fuerst and Kang (2004) states that there is positive influence between independent commissioners and corporate performance, meaning that the fraud committing company is the company that has lower percentage of external commissioners. The greater the number of independent directors owned by the company, the smaller the moral hazard actions undertaken by management that the company performance will continuously increase (Effendi, 2008) . This makes market positively react to generate the improvement of financial and stock performance.

H2: Independent Commissioner has positive influence to market reaction

Audit Committee Influence to Market Reaction

The audit committee is a committee established by the board of commissioners who has the responsibility to undertake independent monitoring on the process of financial statements and external audit. In terms of financial statements, roles and responsibilities of audit committee are to monitor and supervise the financial statement audit and to ensure that the prevailing standards and financial policy are perfectly met. The audit committee also re-examines whether the financial statements are in accordance with standards and policies and whether are in line with other information known by the members of audit committee, as well as assesses the quality of services and the reasonableness of the proposed cost by the external auditors (KNKCG, 2002).

Effendi (2005) states that the recently existence of audit committee is accepted as part of good organizational corporate governance. Besides, the presence of audit committee lately has positive response from various parties, including Government,

Security and Exchange Commission (BAPEPAM), Jakarta Stock Exchange (JSX), Surabaya Stock Exchange (SSX), Investors, Legal Profession (Advocate), Professional Accountants and Independent *Appraisal*.

Klein (2002) provides empirical evidence that companies which establish independent audit committee reported earnings containing smaller discretionary accruals compared to companies without independent audit committee. The discretionary accrual content is related to company earnings quality. Price Waterhouse (1980) in Jama'an (2008) states that investors, analysts and regulators consider that audit committee has a great contribution on the quality of financial statements. The audit committee improves integrity and credibility of financial statements through the board of commissioners.

The audit committee is an agency established by the board of commissioners to audit company operation and reliability. This agency is in charge of selecting and assessing the company performance of public accounting firm. Siegel (1996), in Jama'an (2008) state that audit committee is an agency established within the client company to maintain the accountant independence to supervise management. Supriyono (1998) defines that audit committee serves to provide views on issues relating to financial policies, accounting, and internal controls.

H3: The audit committee has positive influence to market reaction

RESEARCH METHODS

Research Samples

The samples of research are obtained with *purposive sampling* method with the following criteria: (a) all go-public companies excluding banks and other financial institutions. Financial institutions are not included in the samples to avoid the impacts of certain regulations with particular characteristics that potentially influence research variables; and do not apply other policies (*stock split, option conversion, bonus shares, dividend shares, stock dividends*, etc.) during the observational period. Based on above criteria, 34 companies are obtained as samples.

Data Collection Procedure

The data are collected with secondary survey. Secondary survey is conducted to obtain secondary data, both numerical and document published in the annual report. Some data/information requires in the preparation of this study consisted of: **Secondary data** comprising: Law and Regulation of Security and Exchange Commission (BAPEPAM), company financial performance data over the last 5 years, annual report, stock price, *return* realization and *return* expectation, Institutional Stock ownership, independent commissioners, number of audit committee members, audit committee report, audit committee meeting frequency, organizational structure, and other supporting data for studies.

Research Variables and Operational Definition of Variables

1. Institutional Ownership

Institutional ownership is the percentage of rights to vote held by institutions (Beiner, et al., 2003). This variable is measured from:

$$\text{Institutional Ownership} = \frac{\text{Stock owned by institution}}{\text{Number of circulating stock}} \times 100 \%$$

Source: Agrawal and Knouber (1996); Beiner et al. (2003), and Jama'an (2008).

2. Independent Commissioner

Independent Commissioner is the unaffiliated board member with the Board of Directors, other board members, controlling shareholders, and free from business relationships or others which potentially influence the ability to act independently or to solely act for the interest of company (Decree of Jakarta Stock Exchange Inc Management Number KEP-315/BEJ/06/2000 enhanced by KNKCG. Independent commissioner variables are measured from:

$$\text{Independent Commissioner} = \frac{\text{Number of Independent Commissioners}}{\text{Total number of the board of commissioner members}} \times 100 \%$$

Sources: Eng and Mak (2003); Jama'an (2008), and Rachmawati (2009).

3. Audit Committee

The Audit Committee is the regulatory agency for company to run its business in accordance with rules and interests of both shareholders and other interested parties (Decree of head of Regulation of Security and Exchange Commission Number 29/PM/2004). The audit committee is measured from (1) audit committee composition, (2) audit committee report, and (3) audit committee meeting frequency. Each item is measured with *dummy* variables and will be given score 1 if the audit committee

composition of company is in accordance with Indonesia Stock Exchange regulations, reports, and meeting frequency. Otherwise, score 0 will be given (Mangena and Pike, 2005; Jama'an, 2008; and Rachmawati, 2009).

4. Market Reaction

The market reaction is reaction that occurs because of the asymmetric information in the capital market (Huang and Thompkins, 2009). This variable is measured with *Cumulative Abnormal Return* (CAR) which is the sum of *abnormal returns* in a given period (Jogiyanto, 2000).

$$CAR_{it} = \sum AR_{it} \dots\dots\dots (1)$$

Description:

CAR_{it} = *cumulative abnormal return* on day t

AR_{it} = *abnormal return* on day t

Methods of Testing Hypothesis

Method of testing hypothesis in this study uses multiple linear regression analysis equipped with SPSS version 19. This analysis is used to find out the positive influence of *corporate governance* structure including institutional ownership, independent commissioners and audit committees to market reaction. Model of this study is as follows:

$$MR = a + b_1InsOwn + b_2IndCom + b_3AC + e$$

Description:

MR = Market Reaction

a = constant

b₁, b₂, b₃ = regression coefficient

InsOwn = Institutional Ownership

IndCom = Independent Commissioner

AC = Audit Committee

DATA ANALYSIS

Institutional Ownership Influence to Market Reaction

Of 34 samples, 4 companies or 11.76 % have institutional ownership of 21% -50% while 30 companies or 88.24 % have institutional ownership of $\geq 51\%$. These results are in line with the *signaling* theory which states that investors will react to value providing companies to their *stakeholders* (Bewley and Magness, 2008). It shows that the company does not optimally monitor its own business. Besides, the institutional investors are not overly concerned to companies undertaking disclosure information on investment opportunities, research and development or other information related to company credibility as they expect more on company *return* (Rachmawati, 2009).

The results of this study are in line with results of previous studies conducted by Na'im and Rakhman (2000); Sularto and Sudarmadji (2007); Rachmawati (2009) who has proven that institutional ownership has no significant influence on voluntary disclosure. Prowsen (1998), Shleifer and Vishny (1997) proved that the large amounts ownership can put the interests of their own that are potentially in contradiction with the other owners. The results of this study is in contrast with the results of research conducted by Khomsiyah (2003) who has found evidence that the institutional ownership has positive influence to information disclosure. Jensen and Meckling (1976); Walfield et al., (1995); Pratama and Mas'ud (2003); Boediono (2005), and Jama'an (2008) states that institutional ownership has significant influence to company performance due to good company monitoring.

Independent Commissioner Influence to Market Reaction

The test results show that of 34 samples, 10 companies or 29.41% have independent commissioners up to 30%, 12 companies or 35.29 % have independent commissioners between 31% to 40%, 9 companies or 26.48 % have independent commissioners between 41% to 50%, and 3 companies or 8.82% have independent commissioners $\geq 51\%$. These indicate that the role of independent commissioners in a company that has committed SEO is effective as the monitoring device as independent commissioners are appointed by the CEO (Chief Executive Officer) or the board of commissioners. In addition, the companies in Indonesia, especially companies that have committed SEO own independent commissioners above the minimum number in accordance with the rules established at least 30% of the total number of commissioner members (Decree of Board of Directors of the Jakarta Stock Exchange (JSX) Number KEP-315/BEJ/06-2000 on Regulation No. I-A).

The results of this study were in line with Mayangsari (2003), Eng and Mak (2003); Fuerst and Kang (2004); Wedari (2004); Guomao and Jianguo (2007); Jama'an (2008), and Effendi (2008) who state that the independent commissioners significantly influence investor decisions. In contrast, the results of this study contradict the results of Chen and Jaggi (2000); Khomsiyah (2003), and Rachmawati (2009) who state that the independent commissioners have no significant influence on disclosure and investors' decision to invest that the market negatively react.

Audit Committee Influence to Market Reaction

Of 34 samples show that 16 companies or 47.06% have complete data (members, meeting frequency, and report), 2 companies or 05.88% have only a number of audit committee members, 3 companies or 08.82% have a number of audit committee members and reports only, another 3 companies or 08.82% only conducted meetings and made reports, 4 companies or 11.76 % have no complete data (number of members, meeting frequency, and report). These indicate that the audit committees have proven very helpful to commissioners in performing their duties, particularly regarding to financial sector and direct responsibility to the board of commissioners. It means that the existence of audit committee can improve the internal control that has the power to enhance the company credibility reducing the *agency problem*.

These results are in line with Wedari (2004); Jama'an (2008), and Kiryanto (2010) who state that companies with audit committee establishment have greater profits than others without it. Besides, the existence of audit committee recently is accepted as part of good corporate governance (Porta et al., 2005). Supriyono (1998) also states that audit committee serves to provide views on issues related to financial policy, accounting, and internal control. However, these results are in contrast with the research conducted by Mayangsari (2003) who finds negative relationship between audit committee and the integrity of financial statements as the reflection of company performance.

CONCLUSION

The purpose of this study is to determine the influence of corporate governance structure to market reaction upon SEO committing companies. Based on data analysis and result discussion having been done, it can be concluded that to predict market reaction, the company can rely on the presence of independent commissioners and audit committee owned by the company.

Theoretically, this research has significant implications for the development of financial accounting theory especially on *agency theory* regarding to good *corporate governance*. The results of this study indicate that the application of *corporate governance* structure (especially the independent commissioner and audit committee) will result in positive market reaction, leading to good financial accounting and corporate governance further researches to analyze other variables that influence market reaction overcoming problems of *agency* and realized *good corporate governance*. For company regulator, this study has the implications on views related to the effectiveness of regulatory enforcement. For company, this research has implications to encourage companies comply the regulations imposed by regulator that good corporate governance will be well established.

The application of *corporate governance* structure supported with reliable and relevant information does not always enable investors to obtain the *cumulative abnormal return* on investment committed in Stock Exchange. In addition the the lack of information access required to apply the analysis models, there were several other limitations such as: the prediction model that only views during SEO announcement, human factor, and lack of understanding among investors related to the importance of company consistent corporate governance application.

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