Corporate Governance and Corporate Value: The Mediating Role of Investment Effectiveness based on Human Capital

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Abstract

The study offers a new concept and theoretical framework for future theory development of Investment Effectiveness based on Human Capital (IEBHC), which combines Agency Theory and Resource-based Theory to fill the research gap between corporate governance and corporate value. Using company goes public data from Indonesia Stock Exchange over the period 2013-2015, this study applies Partial Least Square (PLS) to examine the mediating role of IEBHC in influencing the relationship between corporate governance and company value. The results reveal that IEBHC to be a significant mediator between corporate governance and company value.

Keywords: *IEBHC; corporate governance; corporate value.*

1. Introduction

The purpose of corporate finance is to maximize market value (Brigham and Houston, 2007; Brealey *et al*., 2008). In the modern corporate management, there is a separation between owners and managers, the management and operational authority are left to the professionals. The separation often leads to *conflict of interest* (Shleifer and Vishny, 1997) and lead to *agency problems* that gave rise to *agency cost*. Velnampy (2013) reveals that managers as part of management do not always act in accordance with the interests of company owners, but they tend to pursue their own interests.

Good Corporate Governance (GCG) is associated with the *ownership structure* and supervision structure which is a form of supervision in order that managers always consider the interests of shareholders (Boubakri, 2006). Meanwhile, according to Lins (2003), GCG is expected to be able to control managers so that, in making decisions, it does not benefit themselves but consider the interests of the principal. However, market mechanism has not been effective in developing countries, including Indonesia, so internal mechanism is highly important in the control (Syakhroza, 2003). Then, the challenge in the implementation of GCG is how to find a pattern to maximize wealth creation, so that there is no improper expenses to third parties (Kim *et al*., 2010).

2. Previous Studies

2.1. Corporate Governance and Corporate Value

According to Jensen and Mecking (1976), Agency Theory is defined; the owner delegates his authority to make decisions to managers with the aim to increase corporate value with the compensations in the form of salary, bonuses, incentives, and other compensations. On the contrary, when the shares owned by management increase, the managers have an interest in increasing corporate value. Thus, the increase in the number of shares by managers may potentially increase corporate value.

According to Wei *et al*. (2005), foreign ownership has a positive significant effect on corporate value. The results indicate that foreign investors can monitor management's work well and their presence may enhance corporate value consistently. Similar results are shown in the study of Ruan *et al* (2011). The research of Sulong and Nor (2008) illustrates the contrast in which foreign ownership as part of the corporate governance system has a significant negative effect on corporate value. Lin (2007) conducted a similar study with the results stating that foreign ownership has no effect on corporate value.

In the research conducted by Haddad and Horrison (1993); Chung and Kim (2005); and Nurhan *et al* (2007); show that there is a positive and significant effect between the structure of foreign ownership and corporate value. The other findings contradict the above finding; foreign ownership structure has a negative and significant effect on corporate value (Khouri *et al*. 2004; Zeitun and Tian, 2007; Tan, *et al*., 2007).

Concerning management structure, Sulong and Nor (2008) states that the size of the board has a positive significant effect on corporate value because it can improve the control and monitoring of dividend value, the government policies that affect the company, and foreign ownership in reducing agency cost. The matters can increase corporate value. The similar results have been shown in the research of Oxelheim and Randoy (2001), Latah and Dickins (2012), Babatunde and Olaniran (2009), and Stefanescu (2011). Obradovich and Gill (2013), in their research, states that the big size of the board of directors has a negative effect on corporate value. The similar results have been shown in the research of Kumar and Singh (2013), Haniffa and Hudaib (2006), and Gill and Mathur (2011).

Purba (2004) found that the largest proportion of public shares has a positive relationship with Corporate Performance that impacts on corporate value. However, Sofyaningsih and Hardiningsih (2011) found the evidence that public ownership does not affect corporate value. According to Rosma (2010), public ownership shows the amount of private information that should be distributed to public managers. Therefore, public ownership is considered to have the effect on corporate performance that might be expected to enhance corporate value. Public ownership is a source of company's external funding obtained from equity participation by the public. Public ownership is a minority shareholder in a company as well as playing an important role in a company. Public shareholders will attempt to monitor the behavior of the managers of a company in running the company. In addition, with the presence of public ownership, the company is required to perform GCG (Kiswanto, 2015).

Sulong and Nor (2008) state that the policy for reducing the number of independent boards can maximize corporate value. It is similar to the results of the research conducted by Oxelheim and Randoy (2001), Fallatah and Dickins (2012), Sami *et al.* (2009), and Babatunde and Olaniran (2009). Helland and Sykuta (2005) study show different results; the board of directors consisting of independent directors can perform the task better in monitoring the work and activities of management. Similar results are shown in Abbasi *et al.* (2012), Rouf (2011), and Stefanescu (2011).

In addition, ownership structure, one of the factors that affect corporate value is the presence of an independent board. The need for independent board within a company is to help the company's long-term strategic plan and periodically review the implementation of the strategy (Purwantini, 2011). The research results of Purwantini (2011) and De Zoysa *et al.* (2010) state that independent board does not affect corporate value. In other hand, in the research of Siallagan and Machfoedz (2006), it states that independent board has a significant effect on corporate value.

The presence of independent commissioner is also stipulated in the Regulation of Securities Listing of Jakarta Stock Exchange (JSX). The companies listed on the Indonesian Stock Exchange are required to have an independent commissioner with the provisions of the number of independent commissioners at least 30% of the total number of commissioners. Thus, it will provide a high benefit for the company (Purwantini, 2011).

Dechow *et al.* (1996) state that the independence of corporate boards will reduce fraud in financial reporting. In general, the company's stock price will be higher and increase the company's value. It is in accordance with the research results of Machfoedz Siallagan (2006) which shows that independent board has a positive effect on corporate value.

2.2. Human Capital Investment in Business Phenomenon

Globalization, technological innovation, and tight business competition are forcing companies to change the way they do business. In order to continue to survive, companies must quickly change their business strategy based on labor-based business towards knowledge-based business so that their main characteristic is knowledge (Sawarjuwono, 2003) which can provide a competitive advantage (Rupert, 1998). In a business environment that is more advanced, then, companies increasingly depend on intangible assets (Apreda, 2011), and the measurement of human capital is at the center of major concern in the business community (Wealtherly, 2003).

The speech delivered by Schultz, T.W. (1993) in 1960 entitled *Investment in Human Capital* is the foundation stone of the theory or concept of human capital (HC). According to the World Economic Forum (The Global Competitiveness Report, 2013-2014) among ASEAN countries, Indonesia in the global competition ranks 38th or the lowest of all Asian countries. Similarly, based on the Survey Entrepreneurship of the World Bank, the major inhibitor of investment in Indonesia, one of them, is the quality of human resources (OECD, 2012).

Based on the background above, the research problems were: the effect of the proportion of foreign and public ownership and the number of board of directors and independent directors on corporate performance and value; the effect of the proportion of foreign and public ownership and the number of boards of directors and independent directors on the effectiveness of investment in human resources; the effect of human resource investment on corporate performance and value; and whether the investment in human resources as the mediating variable that mediates the effect of governance factors on corporate performance and value or not.

3. Literature Review

3.1. Agency Theory

The theory describes the relationship between *principal* and *agent*, which link the relationship between the parties who gives the job, in this case the *principal*, and the professional manager who is given the authority as the *agents*. Jensen and Meckling (1976) state that between *principal* and *agent* basically have different interests. In AT, it will arise an agency problem as a result of the parties' (*principal* and *agent*) who are selfish with their respective interests in doing activities together. Due to the conflict, it arises agency cost. The parties should control themselves so that so the agency cost may be reduced (Jensen, 1986).

3.2. Resources based Theory

The emergence of the view that knowledge as a highly strategic company resource company is based on the fact that knowledge can be used to develop competitiveness, valuable, rare, difficult to imitate by competitors and cannot be replaced by other resources (Wernerfelt, 1984). Therefore, it can maintain its life continuity, grow, and gain profit (Grant, 1991).

Company resources are in both real and unreal assets, while in terms of control, according to Barney (1991), the intangible resources can be controlled by a company and allow the company to understand and implement the strategies that can improve the efficiency and effectiveness of the company, namely human resources (Pulic, 1998; Bontis,at.all. 2000). It is capable of evolving with the specifics, and competitive advantage will be acquired by a company (Penrose, 1959). Mayo (2000) said that the basis of the financial value drivers is HC.

However, human capital is a component that is not easily measured (Mayo, 2000; Sawarjuwono et. Al., 2003). HC can be increased when a company can exploit and develop the knowledge, competence, and skills of its employees efficiently. Therefore, HC is a key resource that can create a competitive advantage as the core of RBT. The same conclusion was also delivered by Bassi et al. (2001), Hansson. Bo *et al.* (2003) and Merih Sevilir (2010) that companies which invest more in human development has a better stock market performance, increasing the company's innovative capacity to generate innovative ideas so as to gain greater profits.

3.3. Ownership and Mangerial Structure

Demsetz and Villalonga (2001) and several previous studies resulted in unequivocal evidence for the endogeneity of ownership structure. The studies examined the roles played by the two aspects of ownership structure; the fraction of the shares held by five largest shareholders and the fraction of the shares held by management. However, it is especially not for management share ownership as endogenous. The result of this study is in line with that of Demsetz and Lehn (1985) that ownership structure does not have a significant relationship. In other hand, the research conducted by Shleifer and Vishny (1986) concluded that the increased shareholding by large block shareholders is shown to significantly increase the company's share price.

Share ownership by the individuals from foreign nationals or institutions which is the percentage of the share ownership by foreign individuals or institutions is at least 5 percent (Barbosa and Louri, 2005). On the other hand, it is viewed from the positive side that the entry of foreign investors will have an impact on better corporate governance by applying good governance like in their countries, such as better openness, transparency, and responsibility.

The study tried to look at the relationship between the ownership by foreign parties and its effect on corporate value, and it shows that foreign ownership has a positive effect on corporate value. Utama (2006) conducted a research to see the simultaneous relationship between corporate governance practices and corporate value on the Indonesian stock exchange. He concluded that foreign ownership has a positive and significant effect on the level of 5 percent. Meanwhile, Haddad and Horrison (1993) concluded that foreign ownership can boost productivity but in slow growth, and the finding of Sawalu *et al.* (2012) in the companies located in the Nigerian stock exchange shows that foreign ownership has not been able to improve corporate performance.

The need for independent board within a company is to help the long-term strategic plan and periodically review the implementation of the strategy (Purwantini, 2011). The research results of Purwantini (2011), and De Zoysa *et al.* (2010) state that independent board does not affect corporate value, while in the research of Siallagan and Machfoedz (2006) states that independent board has a significant effect on corporate value .

Dechow *et al.* (1996) state that the independence of corporate boards will reduce fraud in financial reporting. The existence of an independent commissioner is expected to improve the effectiveness of supervision and to strive the improvement of the quality of financial statements. Then, the quality of financial reporting is also getting better, and it makes investor trust to invest in the companies. In general, the stock price will be higher and the corporate value increases (Siallagan and Machfoedz 2006; Sulong and Nor 2008; Oxelheim and Randoy 2001; Fallatah and Dickins, 2012; Sami *et al*, 2009; Babatunde and Olaniran, 2009). The study of Helland and Sykuta (2005) showed different results; the board of directors consisting of independent directors can perform the task better in monitoring the work and activities of management. Similar results were shown in Abbasi *et al.* (2012), Rouf (2011), and Stefanescu (2011).

3.4. Corporate Performance

Corporate performance is the measurement as the assessment basis of corporate operational activity in certain period, which generally is in a period of one year. It is a reflection on the implementation of various policies of the company. A lot of parties have their interests in finding the information on corporate performance. In addition to the owner of a company, the other parties, such as investors, potential investors, and creditors, are also highly interested in recognizing corporate performance. With a good performance, various parties will be interested in dealing with the company. Investors will certainly glance when a company has performed well to invest in the company. Similarly, when creditors see better performance, they are optimistic that the fund given would go back in a specified time. When all the parties consider that the corporate performance is satisfactory, it is a positive signal for various parties.

Performance measurement has undergone many developments, so the measurements use various indicators. The indicators used in performance measurement include: return on assets (ROA), return on equity (ROE) (Uchida, 2006).

3.5. Corporate Value

Corporate value is measured by considering the price of the stock exchange, especially in the secondary market, meaning that the rise and fall in stock prices in the secondary market is a reflection of the ups and downs of corporate value. The increase in stock prices is an indicator that the prosperity of shareholders also increases. The measurement of corporate value is the sum of all values of equity market value which consists of stock and bond market value or the value of long-term debt commonly called the Price-Book Value (PBV).

As described in many studies, corporate performance is the result of the implementation of various policies of a company by the board of directors as the company's managers until the bottom level of workers. In addition, corporate performance is a measure of the success of corporate management. In the assessment of corporate performance, managers must be oriented to the prosperity of shareholders in every policy, and it is a mandate given by the principal to be implemented by the agency.

4. Materials and Methods

The study attempted to synthesize several theories, mainly between agency theory (AT) and Resource-Based Theory (RBT). The data were analyzed using the method of Partial Least Square (PLS). The selection of the PLS method was based on the consideration that, in this study, there were some latent variables which are formed using formative indicator, not reflexive. The reflexive model assumes that constructs or latent variables influence the indicators where the direction of causality of constructs to indicators or manifest (Ghozali, 2011). Furthermore, Ghozali (2011) states that formative model assumes that the indicators affect the construct where the direction of causality from the indicators to the construct.

The population and sample of this research were the companies listed on the Indonesian Stock Exchange from 2013 to 2015. The objects of this research were the companies that reported the costs of Human Resource Development.

5. Results and Discussion

This research basically conducted a study to find the relationship between GCG and corporate performance (corperf) and corporate value (corval) by incorporating the mediating variable of the investment effectiveness based on human capital investment (IEBHC). In this research, we tried to analyze the role of leadership and management structures in good corporate governance mechanism. Management structure used the indicators of foreign and public ownerships. In other hand, the variable of management structure used the board of directors (board size), board of commissioners and independent commissioner, and the corperf used the indicators of return on asset and return on equity. In corval, the indicator used was price book value (PBV) as one indicator to measure corporate value from many indicators in the corporate value measurement.

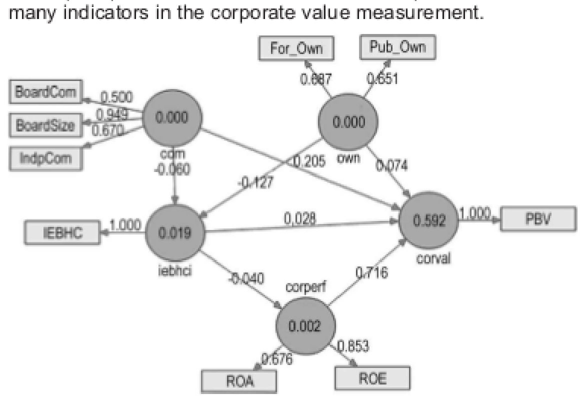

Figure 1. Research Model

Model Measurement in This model defined how each indicator related to its latent variables and specify the relationship between latent variable and the indicators. The outer model tests conducted to outer model are:

5.1. Convergent Validity

Convergent validity value is the value of the loading factor in the latent variables with their indicators. By definition, loading factor is the size of the correlation between the indicators and the latent constructs The use of the indicators was based on the results of PLS analysis. The indicators were the utmost possible because the loading factor value has validity value (See Table 1).

The convergent value validity is the value of the loading factor in the latent variables with their indicators. In most references, the factor weight of 0.50 or greater is considered to have strong enough validation to explain latent constructs (Hair et al, 2010; Ghozali, 2011) although the other references (Sharma, 1996, Ferdinand, 2000) explain that the weakest acceptable loading factor is 0.40.

Variable	Indicator	Loading Factor	Remark
CORPERF	ROA	0.674	Valid
	ROE	0.854	Valid
CORVAL	PBV	1	Valid
IEBHCI	IEBHCI	1	Valid
COM	BOARD COM	0.5	Valid
	BOARD SIZE	0.949	Valid
	INDPCOM	0.67	Valid
OWN	FOR_OWN	0.687	Valid
	PUB_OWN	0.651	Valid

Table 1. Loading Factor

The above variables have relatively high loading factors, which are about higher than 0.5 so that, from the viewpoint of loading factor, all indicators have higher contribution to explain the latent construct.

5.2. Average Variance Extracted (AVE)

AVE value must be greater than 0.5 (> 0.5). Discriminant validity is to compare the value of square root of the average variance extracted (AVE) of each construct with the correlation between the other constructs in the model. If the square root of the average variance extracted (AVE) is larger than the correlation with all other constructs, it is said to have good discriminant validity. It is recommended that the measurement values should be greater than 0.50.

Variable	AVE	Remark
COM	0.532847	Valid
CORPERF	0.592315	Valid
CORVAL	1.000.000	Valid
IEBHCI	1.000.000	Valid
OWN	0.447956	Almost Valid

Table 2. Average Variance Extracted

5.3. Composite Reliability

This value shows internal consistency which is a high composite reliability value indicating the consistency of each indicator in measuring the construct. This value reflects the reliability of all indicators in the model. The minimum value is 0.7 although ideally it is at 0.8 or 0.9. In table 3, all the variables are very reliable, but the Onwersship approaches 0.7.

Variable	Composite Reliability	Remark
COM	0.762031	Reliable
CORPERF	0.741401	Reliable
CORVAL	1.000.000	Reliable
IEBHCI	1.000.000	Reliable
OWN	0.618574	Reliable

Table 3. Composite Reliability

5.4. R-Square

R-Square or known as Stone-Geisser's is a test conducted to determine prediction capability using blindfolding procedure. If the values obtained are 0.02 (small), 0.15 (medium), and 0.35 (large), it can only be conducted for endogenous constructs with reflective indicators.

Variable	R_Square	Remark
CORPERF	0.001609	0.16%
CORVAL	0.591719	59.17%
IEBHCI	0.019331	1.93%

Table 4. R-Square

The goodness test of structural model can be seen from the value of Q^2 as below: $Q^2 = 1 - (1-R^2)$, the value of Q^2 close to the value of 1 is the stated structural model which is also fitted to the data. The results of the test show that the model is not entirely fit with the data or able to reflect the reality and phenomena that exist in the field. The results of the analysis show that only in Corporate Value in which the indicator variable is valid and reliable. It reflects the latent variables with model testing resulting in the conclusion of model fit.

5.5. Path Coefficients

Path Coefficients is the path coefficient value or the size correlation / effect of latent constructs.

Variable	Variable Target	Path Coefficient	Remark
COM	Corval	-0.204849	Negative
OWN		0.073586	Positive
IEBHCI		0.028283	Positive
CORPERF		0.715345	Positive
IEBHCI	Corperf	-0.040116	Negative
COM	IEBHC	-0.060325	Negative
OWN		-0.126995	Negative

Table 5. Path Coefficients

In the output of Path Coefficient as shown in the table above, it is to see the significance of the effect of the variables of Commissioners, Ownership, IEBHC, Corporate Performance, and Corporate Value. By looking at the value of parameter coefficient (original variable) to the target variable, the variables that have positive effects are ownership and IEBHC on Corporate Value and Corporate Performance on Corporate Value. In other hand, the other original variables have a negative effect on the target variable.

Variable	Direct Effect	Indirect Effect	Total Effect	Remark
COM	-0.20484	0.0002	-0.20482	Negative
OWN	0.073586	0.00005	0.073639	Positive
IEBHCI	0.028283	-0.02870	-0.00041	Negative
CORPERF	0.715345	n/a	0.715345	Positive

Table 6. Analysis of Direct Effect, Indirect Effect, and Total Effect

The analysis was used to see the strength of the effect between constructs; the direct, indirect, and total effects. According to Ferdinand (2000), direct effect is a coefficient of all lines with one-end arrow, while indirect effect is the effect that arises through a mediator variable and total effect is the effects of various relationships.

The direct effect of this research model is presented in table 6. In this study, there are four variables that have direct effects on the variable of Corporate Value. The results of measurement show that the variable that has the variable has the greatest direct effect on Corporate Performance, and then followed by the variables of ownership and IEBHC. In this research model, it also measured the indirect effect between the variables; there are four variables that have indirect effect on the variable of

Corporate Value as shown in table 5. From the measurement, the variables that have indirect effects, in general, are very low.

Due to the direct and indirect effects between the variables in this research model, it is necessary to measure the total effect. The results of the total effect measurement between the variables are shown in table 6. Based on the measurement results, it shows that the variable that has the greatest total effect on Corporate Value is the variable of Corporate Performance at 0.715345.

5.6. Effect Size

Effect size is a measure of the size of the effect of a variable on another variable, the size of the difference and relationship which are independent from the effect of sample size (Olejnik and Algina, 2003). The related variables are usually response variables or also called independent and outcome variables, or often called dependent variables. Effect size can also be considered as a measure of the significance of research results in practical terms (Huck, 2008).

Variable	R^2 included	R^2 excluded	F^2 effect size	Remark
COM	0.592	0.550	0.103	Small
OWN	0.592	0.587	0.122	Small
IEBHCI	0.592	0.591	0.002	Small
CORPERF	0.592	0.093	1.223	Large

Note: the Formula: f-square effect size = (R square included – R square included) / (1 – R square included)

Table 7. Effect Size

Cohen (1988) provides a reference to effect size that can be said to show a strong effect size (Cohen, 1988); f = 0.1 (small), f = 0.25 (medium), and f = 0.4 (big). However, the reference is a temporary reference given by Cohen (1988) if no prior research has been made in the field under a study. The determination of effect size is closely related to a particular field of research. For example, in human behavior studies, we cannot expect large effect size (e.g, R square is close to 1) due to many factors that influence human behavior (Cohen, 1988). Based on the above reference, the strong effect size is from the variable of Corporate Performance, while the other variable is medium and the variable of IEBHC has the effect size of weak.

5.7. Hypothesis Testing

The model test in the PLS approach was conducted through the outer model. Outer model tests an indicator against latent variable or, in other words, measures how far an indicator describes its latent variable. The indicators used in this research were reflective indicators. The outer loadings of a research model using reflective indicator can be seen from the correlation between the indicator value and the construct value. An individual indicator is considered valid when it has the correlation value higher than 0.70 and t-statistic significance > 1.645 for one-tailed hypothesis.

Table 8. Path Coefficient Significance

Original Variable	Target Variable	T-Value
COM	Corval	3.535*
OWN		1.232**
IEBHCI		1.327**
CORPERF		6.903*
COM	Iebhci	1.966*
OWN		3.002*
IEBHCI	Corperf	1.215**

Note: *Sig 95% ** Sig < 95%

Based on the inner model test (the test of effect/ hypothesis test) that had been conducted, the path coefficient was found that the correlation between management structure (COM) and Corporate Performance (CorPerf) with corporate value (Corval) is significant with T-statistic equal to 3,535 (> 1,645). The relationship between ownership (Own) and IEBHC with corporate value (Corval) is significant, but with alpha more than 5%. In other hand, the relationship between management structure (COM) and ownership (Own) with IEBHC is more significant with T-statistics of 3.535 (> 1.645), and the relationship between IEBHC and corporate value (Corval) is significant, but with alpha more than 5%. See table 8.

In this study, corporate governance was distinguished between ownership structure and management structure; both structures were measured using five indicators, the financial performance was measured using two indicators, and corporate value was measured using one indicator. The results show that corporate governance and corporate performance and governance of ownership structure and management structure also have the significant effect on IEBHC, but IEBHC is not significant on corporate performance.

6. Conclusion and Limitation

Based on the research results and discussion above, it can be concluded that ownership structure and management structure have a significant effect on corporate value. The relationship of ownership structure and IEBHC with corporate value is also significant, although the level of significance is more than 5%. Similarly, the relationship between IEBHC with corporate value is also significantly with the level of significance of more than 5%. IEBHC has a negative effect on corporate value due to a very small number of shares owned by the managements.

The results of the measurements show that the variable with the biggest direct effect is the variable of Corporate Performance, which is followed by ownership and IEBHC. The research model also measured the indirect effect between the variables; there are four variables with an indirect effect on the variable of Corporate Value as shown in table 5. From the measurements, the variables with indirect effect, in general, are very low.

Recommendation

In future research, it is expected to consider the samples differentiated between companies based on technology and non-technology, so that the results can be compared with this study. Further research is also suggested to increase the number of samples or to add the year of research.

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