

THE EFFECT OF GOOD CORPORATE GOVERNANCE IMPLEMENTATION IN DIVERSIFICATION STRATEGY OF FAMILY COMPANY AND ITS EFFECT ON FIRM VALUE

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Abstract

Purpose: This study aims to analyze the relation of GCG implementation and diversification strategy in the family company and its effect on the corporate value that is proxied with returns of corporate share (cumulative abnormal return - CAR).

Methodology: This study used control variables which were size, age, and growth of the company. The hypothesis test was done by using multiple regression and an average T-test. The samples of this study were companies listed in Indonesian Stock Exchange that have fulfilled the characteristics of concentrated share ownership by one family. This formulated two-equation models i.e. Dependent variable for equation model I was diversification strategy and for equation model II was corporate value.

Results: The result of this study shows that management compensation, independent commissioners, and managerial ownership positively affect, while the number of the audit committee and leverage ratio do not affect diversification strategy. The next testing result was a diversification strategy applied by the family company that positively affects corporate value.

Implications: In order to conduct a controlling function, a company must plan the existence of good corporate governance (GCG) that organizes the relation and responsibility between many parties involved in the company, that a number of regulations, policies, and procedures. The implementation of GCG is expected able to guarantee the action of management in line with the interest of shareholders.

Keywords: *Cumulative Abnormal Return, Good Corporate Government, Leverage, Diversification Strategy, Corporate value.*

INTRODUCTION

Background

Quality of corporate management determines performance; one of them is related to the existence of good corporate governance (GCG) that organizes relation and responsibility between many parties involved in the company. Mechanism of GCG (internal and external mechanism) will guarantee management's action in line with the interest of shareholders, including composition of board of directors/commissioners, managerial ownership, and executive compensation, as well as controlling by market and debt financing level (Larcker, et al., 2007), that also will affect performance. GCG application will give advantages, among others are minimizing agency costs by controlling interest conflict that might occur between shareholders and management, minimizing the cost of capital, so it increases corporate value and increases corporate image through the improvement of financial performance and perception of stakeholder toward better future of the company.

Implementation of GCG will reduce the opportunistic action of management, then generates the best business decision making and be more efficient that will protect the interest of the company's owner. Thus, the company's management will choose the best business strategy to increase corporate value; among others is applying diversification strategy. If a company's management is able to conduct the strategy properly to manage resources efficiently, it will be able to bring profit more quickly. For the management of the company, this diversification strategy is not only a private investment but also is a strategy that is able to increase the welfare of shareholders. With new additional business segment, the change in an organization certainly happens, for example, the change in administration structure, organization, and function of the internal system, and process of business management. (Rahmawati, et.al 2018).

The advantages of the business diversification strategy felt by the company are the presence of a bigger market, more efficient resource allocation, the use of existing resources in a new segment, and the appearance of synergy between existing segments. All advantages are expected able to increase corporate performance in the future. Diversification strategy brings up a number of competitive advantages because diversification allows the company to use the bound between different businesses, so it causes costs and other competitive advantage differentiation compared to business competitors (Markides and Williamson, 1994).

Nevertheless, there are various study results related to the relationship between business diversification strategy application and corporate performance that will increase corporate value. For example, the result of a study done by [Palich, et al. \(2000\)](#), stating that there is a non-linear relation between diversification and organization performance. The study was done by [Piscitello, \(2004\)](#) stated that business diversification has a positive effect on corporate performance. Contrarily, the studies have done by [Lins & Servaes \(2002\)](#) and [Gary \(2005\)](#) stated the result that business diversification has a negative effect on corporate performance and even there is no relation between both of them ([Grant et al., 1988](#), and [Montgomery, 1985](#)).

A company with a category of share ownership that is concentrated on one family enables a very active involvement from management and founder (stockholder). This condition might affect agency relations between stockholder and management of the company. [Jensen and Meckling \(1976\)](#) stated that agency conflict occurs lower in the family company, but [Villalonga and Amit \(2006\)](#) and [Young, et al. \(2008\)](#) stated that agency problem faced by the family company is bigger, related to the interest problem between family stockholder and minority stockholders. Regarding the intervention of the family side that is very active, GCG implementation shows that the family company has a supervision level that is very high toward operational activities and is done by management, so it will give a guarantee that stockholders include in choosing business diversification policy.

Related to diversification policy in the family company, [Gómez-Mejía, et al. \(2010\)](#) stated that family company dislikes diversification strategy because it is considered risky that will need costs and human resources, so it causes threat toward the welfare of the stockholders. However, [Anderson and Reeb \(2003\)](#) stated different thing, that the reason not conducting diversification policy is more to the lack of knowledge about acquisitions and new business based on the competitive advantage of the company, as stated by [Miller, et al. \(2008\)](#) that top management of company has commitment and quality that are relatively high. Both opinions imply that diversification has a negative effect on corporate performance ([Gómez-Mejía, et al., 2010](#)), while [Anderson and Reeb \(2003\)](#) stated the opposite.

Based on the description above, that there is opposite effect related to the relation between diversification strategies toward corporate performance, this study will investigate the effect of GCG implementation on diversification strategy done by a family company and it is followed by the investigation of business diversification effect on corporate value in the following period.

Research Questions

This study raises issues in accounting science related to the relation between the implication of good corporate governance and business diversification strategy choice and its effect on corporate value in the following period. The problems of this study are formulated as the following:

1. Does management compensation of family companies affect diversification strategy?
2. Does the size of the board of commissioners of family business affect diversification strategy?
3. Does the number of the audit committee of a family company affect diversification strategy?
4. Does managerial ownership of family companies affect diversification strategy?
5. Does the leverage ratio of a family company affect diversification strategy?
6. Does diversification strategy affect the value of the family company in the following period?
7. Is there any difference between the value of a family company that applies a diversification strategy and the one that does not apply diversification strategy?

LITERATURE REVIEW

Agency Theory

This study uses the rationale that is explained by agency theory, that good corporate governance as protection toward the interest of stockholders and stakeholders from opportunistic action of management that pushes management to increase its performance in order to increase corporate value, so it is able to increase the welfare of interest parties, especially stockholders. Agency theory explains that there is an operational function separation of an entity that is in the side of the agent (management). Between principal and agent, they have different interests that tend to cause agency conflict ([Scott, 2009](#)).

In a family company, the emergence of agency problem is more, not significant compared to non-family company, related to the conflict between principal and agent ([Jensen and Meckling, 1976](#)). An agent who has the tendency to prioritize its own utility tends to reject a policy that can threaten its position as manager. Meanwhile, the principal party is having difficulty in conducting controlling function, supervision, and assessment properly that is able to control management action in order to be in accordance with its interest. This agency problem indicates that corporate value will be increased if the owner of the company can control management so that management does not behave inefficiently by wasting resources of the company, such as improper investment or shirking behavior. ([Nurdiono Nurdiono, et al 2019](#))

Good Corporate Governance

According to [Gillan and Starks \(1998\)](#), corporate governance is a legal system, regulation, and factors to control the company's operation, that is expected to be able to prevent opportunistic action of management in allocating corporate resources, so it can give profit and is able to increase the welfare of stockholders through the increase of firm value. Effective corporate governance in the long-term can increase corporate performance and profitable for stockholders because it helps the company in conducting analysis toward investment and increasing economic performance as well as competitiveness, by promoting transparency on all transactions. Moreover, it is able to create controlling that limits the misuse of power toward corporate resources and to provide the means of supervision of manager's behavior to ensure corporate responsibility ([Oman, et al., 2004](#)). Corporate governance is not only for maximizing firm value, but also referring to the ethics and transparency, social responsibility (CSR), especially regarding the globalization that often faces many more favorable jurisdiction choices ([Fundeanuand Badele, 2014](#)).

The family company has concentrated share ownership structure that is in the hand of one family that will have the goal-achieving process of the company that is very effective because it gets supervision from stockholders. This condition pushes management to act more efficiently. Therefore, corporate governance in family company automatically runs well, as the result of a study done by [Jiraporn & DeDalt \(2009\)](#), that discipline of manager in family company limits opportunistic actions of management with the reason that management of family company has the main goal to increase the wealth of company and family, and to keep the company for upcoming generation ([Chen, et al., 2015](#)).

Management Compensation

Managerial expertise and skills are really related to the financial performance of an organization. Therefore, it needs a good understanding of the level of compensation given to the management with the size of financial success. Stockholders use the scheme of corporate compensation as the instrument to monitor and/or to motivate managers. The stockholders want the manager to take action to maximize the value of the organization for the owner and other stakeholders ([Jensen and Murphy, 1990](#)). Some studies show the presence of a significant relationship between managerial compensation and financial performance, market performance, and firm size. Generally, the compensation plan is based on the size of the manager's achievement which is net profit and share rate ([Scott, 2009](#)). Some study results concluded that the use of accounting information to evaluate management's performance can cause employee or manager to have tension, revenge, suspicious to a co-worker, anxiety, and lack of confidence, that cause dysfunctional behavior, such as the presence of a tendency to manipulate accounting data. [Farichah \(2017\)](#) found that there is a relation between compensation and management behavior. However, if management compensation is determined based on corporate profit, it will cause deviant management behavior, such as management tendency to report high profit aggressively.

Management of family company tends to have the commitment and high loyalty toward the company. According to [Miller, et al. \(2008\)](#), top management has commitment and quality that is relatively high, so management will take action in line with stockholders, and really focus on profit that will increase the welfare of stockholders. Management that has high commitment and loyalty toward the company shows that the company has good GCG implementation that can be reliable as a strong controller toward management opportunistic action. Regarding the characteristics of family company management and its relation with diversification strategy, management of the family company will conduct selection to do the strategy, as long as it is beneficial for the company that will increase the welfare of management and stockholders.

The Number of Board of Commissioners

Board of Commissioners has an important role in corporate governance, which is an internal control role that is responsible as stockholder representative to make the best decision for the company and stockholders ([Gillan, 2006](#)). Moreover, the board of commissioners is also in charge of advisory and supervisory of management, as well as having a responsibility in recruitment, dismissal, and determination of the amount of management compensation ([Jensen, 1993](#)). The company can arrange the number of commissioner board with the size in accordance with the existing business complexity. Effectiveness of the board of commissioners is measured by the proportion of independent commissioners that are the commissioners not from the company's employees, not from a relative/family of majority stockholders and do not have a business interest in the company ([Nam and Nam, 2004](#)). The appointment of independent commissioners significantly increases the independence of the commissioner board and more effective in fulfilling the interest of the company and all stockholders and not only for the interest of majority stockholders. [Coles, et al. \(2001\)](#) stated that the more independent commissioners that are represented will increase the controlling function of strategy from commissioners. Through strict supervision, independent commissioners can reduce the excessive risks that are taken by non-independent commissioners. The existence of a good board of commissioner structure, it is expected able to be the controller for corporate management for not acting opportunistically that only prioritizes their own interest and ignore the interest of stockholders and investors.

The Number of Audit Committee

Member of the audit committee is responsible for the supervision of financial reports, internal controlling system

(including internal audit) that can reduce management opportunistic nature. The audit committee has functions, among others, are ensuring that the financial report that is reported by a company can be reliable, presented reasonably, and not misleading. Then, the audit committee also has the task to conduct supervision and follow up toward the possibility of material irrelevance that occurs in the financial field and implication in law. Therefore, the existence of an audit committee will increase the integrity and credibility of the financial report, so it indicates reduced measurement and improper accounting information disclosure because of the reduced fraudulent actions and illegal actions done by management. Thus, the existence of an audit committee shows that the implementation of GCG in the company has been done well.

Managerial Ownership

[Shleifer and Vishny \(1986\)](#) stated that the big stock ownership from the side of economic value has controlling incentives toward the company's operational. If some company's stocks owned by management, the management will be motivated to increase corporate performance that its result is not only felt by stockholders and investors from outside but also felt by management as the stockholder. Theoretically, when the ownership of management is low, the incentive toward the possibility of the occurrence of the manager's opportunistic behavior will be increasing. Management ownership toward company's stocks is considered able to harmonize the potency of interest difference between external stockholders and management ([Jansen and Meckling, 1976](#)), that will eliminate agency problem, as stated by [Black, et al. \(2003\)](#) that company managed well will be more profitable, so the number of dividends that are shared higher. It makes external investors can conclude that the company has applied corporate governance better by conducting evaluation toward earnings or shared dividends.

Ratio Leverage

The leverage ratio is a ratio of debt on assets of the company. Debt can be one element of corporate governance that is able to control the manager's opportunistic behavior in managing the company. With the presence of debt, a manager is motivated to manage resources efficiently to produce a performance that is able to increase optimal results to pay the debt. Therefore, debt is used to change the goal and aspiration of a manager that is fully to maximize the assets of the company ([Jensen, 1986](#)). A manager who has the responsibility to maximize the interest of stockholders chooses the decision that is in line with the interest of the creditor. On the other side, stockholders can take profit through the loss that is borne by the creditor. Managers can reduce the value of debt by issuing new debt that can increase the risk of the company. This increased risk shifts the advantage from the creditor to stockholders, although it must be compensated with the decreased market value of the company. Rational creditors will protect their interest by increasing credit interest and protective covenants. The existence of a debt contract can reduce the costs of bankruptcy that eventually will increase the firm value.

Diversification

[Jensen and Murphy \(1990\)](#) stated that diversification is management discretion to increase the firm size that enables the manager to get higher compensation, to reduce personal risk, to guarantee job position and bigger power. Contrarily, according to [Meyer, et al. \(2009\)](#) this investment causes bigger agency costs, so it negatively affects corporate performance and results in inefficient resource allocation and reduces the firm value ([Berger and Ofek, 1995](#)).

There are three relations between diversification and corporate performance ([Palich, et al., 2000](#)), in which the first model is a linear premium model stating that diversification linearly and positively relates to corporate performance. The second relation model is linear discount model assuming that diversification linearly, but negatively relates to corporate performance, while the third model is model U assuming that it positively relates to corporate performance, when there is a change of business of the company from single business to related diversification, and will negatively relate when the company move to diversification that is not related to the main business.

A company that is diversified has more accesses internally to various resources including external financing so that it causes more flexible capital formation. Many mechanisms can be used to create and expand the advantage of market power owned by the company, among others are price-cutting, income excess from a segment can be allocated to support other segments (cross-subsidies), to increase obstacle entering the industry. Another mechanism that can be done by the company is expanding special assets of the company, and to share resources among segments, such as brand names, managerial ability, customer loyalty, and technology innovation.

Firm Value

There are some studies that try to connect the variable of the capital market and the special variables of the company. For example, [Beaver, et al. \(1970\)](#) found the presence of relation between stock return and some variables of corporate performance, such as dividend payout, financial leverage, and earnings yield. Previous research by [Fama & French \(1996\)](#) found that a return average of the stock is usually related to the characteristics of the company such as size, earnings/price, selling growth, long-term stock return, and others. The study of firm value cannot be separated from the return level, dividend payout, financial leverage, firm size, and earnings/price. In the relation between diversification and corporate performance, in general, the potential return of diversification decreases along with the presence of market and institutional development, so diversification does not improve corporate performance in a perfect market. [Chakrabarti, et](#)

al. (2007) stated that a company in a less developed economy will enjoy the advantage that is more sustainable from the implementation of diversification rather than the company in a more developed economy institutionally. However, the studies done by [Hernández-Trasobares and Galve-Górriz \(2017\)](#) did find any significant relation between diversification and performance related to the joint strategy of the company. The company chooses to conduct diversification if the advantage of diversification is more than costs or vice versa, the company chooses to be focused. [Hoechle, et al. \(2012\)](#) found a significant negative relation between diversification and corporate performance. This condition can be explained by the variable of corporate governance stating that GCG is related to the increase of firm value when conducting merging diversification.

The study about diversification as a strategy to increase firm value has also been done by [Villalonga \(2004b\)](#), although diversification strategy also needs bigger costs. From a resource-based perspective, diversification gives operational synergy based on the scope and economic scale, which will increase efficiency. From a market power perspective, diversification gives an advantage in competition against competitors ([Seth, 1990](#) and [Valentinovna, Nosova Olga, 2018](#)). According to the financial approach, there is a coinsurance effect, to reduce risks emerging from the business merger that less has cash flow ([Lewellen, 1971](#)). Implementation of diversification strategy gives the means that can be reliable to fulfill financing needs from internal sources. The study done by [Kuppuswamy and Villalonga \(2016\)](#) gave new evidence that diversification produces efficiency in the internal capital market.

Hypothesis Development

Relation of GCG and Diversification Strategy

According to [Larcker, et al. \(2007\)](#), the mechanism of corporate governance includes internal and external mechanisms such as management compensation, the composition of the board of commissioners, audit committee, managerial ownership, and leverage ratio. Therefore, corporate governance must include elements such as the ones mentioned in corporate governance. [Fundeanuand Badele\(2014\)](#) stated that corporate governance is not only maximized firm value but how to conduct more profitable jurisdiction choices. Regarding characteristics of family company management and its relation with diversification strategy, family company management will conduct the choice to run the strategy, as long as it is profitable for the company that will increase the welfare of management and stockholders that is viewed from the firm value. Therefore, the hypothesis of this study is formulated as the following:

- H-1: Management compensation positively affects diversification strategy.
- H-2: The number of independent commissioner board positively affects diversification strategy.
- H-3: The number of audit committee positively affects diversification strategy.
- H-4: Managerial ownership positively affects diversification strategy.
- H-5: Leverage ratio positively affects diversification strategy.

Relation of Diversification Strategy and Firm Value

This study refers to the study done by [Villalonga \(2004b\)](#) that by applying diversification strategy, the firm value will be increasing because with the presence of increased corporate performance that will be interesting information for investors and potential investors to conduct investment in the company. If the demand for the stock is increasing, automatically it will increase stock rate in the stock market that eventually will increase stock return. Thus, it will increase related firm value, although [Hernández-Trasobares and Galve-Górriz \(2017\)](#) did not find evidence that can explain the relationship between implementation diversification strategy and corporate performance. Then, [Hoechle, et al. \(2012\)](#) found a negative and significant relationship between the implementation of diversification strategy and corporate performance. Therefore, the hypothesis of the study is formulated as the following:

- H-6: Diversification strategy affects the value of the family company.
- H-7: There is a difference between the value of a family company that applies a diversification strategy and a family company that does not apply a diversification strategy.

METHODOLOGY

Data Collecting

This study uses available data through the accesses as the following:

- a. Indonesia Stock Exchange (IDX)
- b. Indonesian Capital Market Directory (ICMD); financial data from 2013 to 2017.
- c. www.bei.co.id
- d. www.google.com/search

Sample of Study

The sample of the study is the companies with stock ownership in the category of family companies that are listed in IDX from 2013 to 2017. The criterion of the family company is the stock ownership $\geq 30\%$ in 1 family or one name of the owner who is considered as a family company. The criterion of the non-family company is the company with stock ownership held by more than 1 owner.

Variable of Study and Measurement

This study uses two-equation models. Equation model 1, management compensation (Compen), number of independent commissioner board (Comis), number of the audit committee (Comaud), managerial ownership (Comgr), and leverage ratio (Lev) as independent variables with diversification strategy (Divr) as the dependent variable. Testing with equation model II, diversification strategy (Divr) as an independent variable with firm value (Valf) as the dependent variable. This study also includes control variables of firm size (Size), firm age (Age) and firm growth (Gro).

Measurement of Dependent Variable

Measurement of variable diversification (Divr) is done by using the Herfindahl-Hirschman Index that is measured from the number of squares from sales of each segment divided by the total sales of the company ([Liebenberg & Sommer, 2008](#)). Measurement of variable corporate performance is placed as a dependent variable, using the proxy of cumulative outstanding stock market rate (CAR) at the end of the reporting period ([Hartono, 2013](#)).

Measurement of Independent Variable

Companies measured by logarithm from the number of burdens spent by the company for management expenses post (employee) for one period that is reported in the financial report. Comis is measured by the presence or the absence of independent commissioners. Comaud is measured by the presence or the absence of an audit committee formed by the company. Comgr is measured by the presence or the absence of stock owned by corporate management. Lev is measured by the ratio of debt on assets of the company. This study uses variables of firm size (Size), firm age (Age), and firm growth (Gro) as controlling variables that are measured with logarithm from the total assets of company for variable Size, natural logarithm of the firm age for variable Age, and the logarithm of sales total change, and the logarithm of sales total change from present year for variable Gro.

Testing of Study Hypothesis

The testing of hypothesis H-1 to H-6 uses regression analysis (Ordinary Least Square - OLS) to disclose the relationship of the effect of the independent variable on the dependent variable. The testing on these hypotheses is completed with the classical assumption test, and F-test, and t-test. Hypothesis H-& is tested using Compare Means-independent Samples T-Test.

Analysis Model

Analysis model used to test H-1 to H-5 formulated in this study is multiple regression with equation models as the following:

Equation Model I:

$$Divr = a_1 + b_{11} Compen + b_{12} Comis + b_{13} Comaud + b_{14} Comgr + b_{15} Lev + b_{16} Size + b_{17} Age + b_{18} Gro + e_{1i}$$

Equation Model II:

$$Valf = a_2 + b_{21} Divr + b_{22} Size + b_{23} Age + b_{24} Gro + e_{2i}$$

DISCUSSION

The testing result of the effect of management compensation and independent commissioner on diversification strategy shows a positive and significant effect. It means that fair compensation determination pushes management to conduct diversification implementation as the form of responsibility from executives in running duty to increase performance effectively and innovatively, which promotes the presence of creativity that enables diversification implementation. Although according to [Gómez-Mejía, et al. \(2010\)](#) implementation of diversification policy in the family company is less liked because it is risky, that will need bigger costs and human resources, so it causes a threat toward the welfare of stockholders.

While independent commissioner of a company is able to encourage executives to act positively, as business diversification strategy implementation that is able to increase corporate performance. ([Nurdiono Nurdiono, et al 2019](#)). Thus, it can be meant that an independent commissioner is one of element from GCG that is able to decrease opportunistic action of management, and will create positive motivation to make the best business decision, and improve the ability to run the business more efficiently, as well as protecting the interest of the owner of company.

Meanwhile, managerial ownership, audit committee, and leverage ratio do not affect diversification strategy. This conclusion supports the thought of [Gómez-Mejía, et al. \(2010\)](#) that family company is less favorable because it is

considered to have risks that cause the threat toward the welfare of stockholders, including managers and executives. Moreover, although the existence of audit committee members also can reduce the opportunistic nature of management, in the family company, the possibility is less needed. It is because the family company has very active participation from management from the family of stockholders or the founder of the company, so the internal supervision is adequately done by corporate management. Moreover, although [Larcker, et al. \(2007\)](#) stated that debt financing level is one element of good corporate governance implementation, for a company under the control of family with management that is mostly from the family member of the owner, it might decide to prioritize the internal financing sources as the operational financing sources of company.

Company that applies diversification strategy will have access internally and externally to various resources, so it is able to operate more flexibly, create and expand the market benefits owned, and is able to expand for using advantages of assets and various resources among segments, such as brand names, managerial ability, customer loyalty, and technology innovation. As the study was done by [Kuppuswamy and Villalonga \(2016\)](#), it gave new evidence that diversification produces efficiency in the internal capital market. The ability owned is the potential achievement of better corporate performance that is able to generate an increase in firm value.

CONCLUSION

This study succeeded to reveal that variables of management compensation and independent commissioner significantly affect business diversification strategy implementation in the company that is categorized as a family company. It means that a family company with an adequate compensation system and independent commissioner tends to have the willingness to apply a business diversification strategy. Meanwhile, managerial ownership, audit committee, and leverage ratio are proven do not affect, meaning that managerial ownership, audit committee, and leverage ratio level of a family company tend to be meaningless to management in conducting diversification strategy implementation.

This study is also able to prove that the variable of business diversification that is implemented relates positively and affects the firm value that is proxies with the magnitude of cumulative abnormal return. It means that the applied diversification strategy is able to increase firm value. If diversification strategy is run well, there will be a company's operationalization system that is done efficiently as well as good synergy among units, so it is able to encourage the increase of firm value. It is also shown by the result of this study that it is also able to reveal that the value of a family company that applies a diversification strategy bigger than a family company that does not apply the strategy.

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