Corporate Governance Perception Index (CGPI) and Cost of Debt

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Abstract

Corporate Governance Perception Index (CGPI) is the ranking of good corporate governance by Indonesian Institute for Corporate Governance (IICG) with SWA magazine. Companies that follow the CGPI survey showed a willingness to become a trusted and open. This effort should be perceived positively by stakeholders. Some previous researches showed that a corporate governance has a significant impact on the lowering the cost of debt (Piot & Piera 2007; Sengupta & Bhojraj 2003; Ashbaugh & Skaife et al 2006). Therefore, this paper is aimed to search the benefit of GCG implementation to the cost of debt. All companies listed on the Indonesia Stock Exchange (IDX) which have a GCG score for survey period 2004-2009 are selected as a research sample. Other variables such as Debt to Asset (DA), Return on Asset (ROA), Sales Growth (Sgrowth), Firm Size (Fsize and Market to Book (MTB) are considered as control variables. The results do not support the hypothesis. Several explanations, including the low level of creditor's confidence to the good corporate governance practices have been discussed to support the research findings.

Keywords: Corporate Governance Perception Index (CGPI), CG Score, Cost of Debt, Firm Size

1. Introduction

The implementation of Good Corporate Governance (GCG) can be indicated by applying of GCG's principles, such as transparency, accountability, responsibility, fairness and independency. GCG emphasizes on stakeholder right to get precise, transparent and timely information about company's performance and ownership (Sulistyanto & Meniek, 2003).

The role of GCG's principles to the cost of debt (CoD) have been searched by Chen & Jian (2007), the conclusion is transparency in providing information will diminish default risk and finally reduce the CoD. Piot & Piera (2007) searched the affect of GCG and audit quality toward CoD, the result showed that there is a significant affect of GCG to the CoD. Rinaningsih (2009) also proved that GCG and Bond rating have significant association. Prior them, Sengupta & Bhojraj (2003) have iniated to research affect of GCG to the Bond Rating using 1005 Bonds issued between 1991-1996. The results showed that companies which implement GCG enjoyed higher bond rating.

To promote implementation of GCG, Government of Indonesia (GoI) through Indonesia Institute of Corporate Governance (IICG) has iniated to rank the level of GCG implementation (Suprayitno et al. 2005). Regularly, since 2001, IICG conducted research to evaluate GCG practices by companies. The ranking was namely Corporate Governance Perception Index (CGPI). There are ten aspects of GCG which assessed i.e (1) the company's commitment on GCG, (2) transparency, (3) accountability, (4) responsibilities, (5) independency, (6) fairness, (7) competence, (8) mission statement, (9) leadership and (10) staff colaboration.

Scoring of the ten aspects then categorize into 3 level i.e highly trusted (score 85.00-100.00), trusted (score 70.00-84.99) and adequate trusted (55.00-69.99). Number of CGPI's participant since 2001 is presented in figure 1.

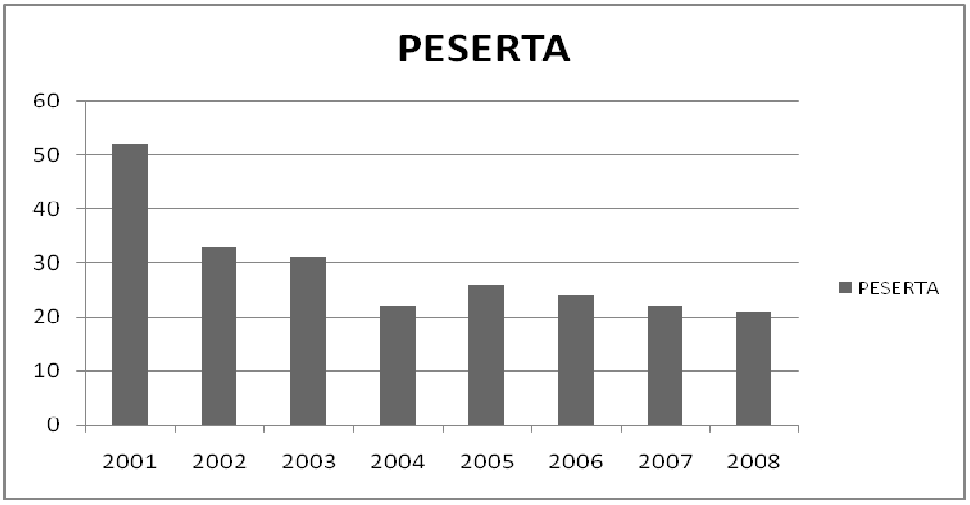


Figure 1. CGPI Participant

According to Miharjo (2008), GCG implementation is costly since companies are required to have independent commisioner, audit committee, tranparent accounting information system etc. Besides that, companies' participation in the CGPI research will add management's tasks. Therefore managements expect that their participation in the CGPI research will offer some gains such as increasing investor and creditor confidence, lower cost of capital, efficient and effective resources allocation which finally lead to maximize stakeholder value.

However, figure 1 shows that the participation of the companies in the CGPI research tends to be go down. Binhaldi highlights three main factors explain the drop of CGPI participation: (1) the lack of promotion and marketing of CGPI events, (2) a number of companies do not feel confidence with their GCG implementation, (3) some companies have realized the potential benefits of GCG implementation but it is not worth the effort and the benefits derived through achieving the level of CGPI. (SWA Magazine No 26/XXII/11)

It is interesting to investigate whether the benefit of implementing GCG really exist. Although some previous research support that some benefits exist, but the decreasing of participant in GCG survey on the other hand imply that the benefit still questionable.

2. Hypothesis Development

CoD is the return that must be received by the creditors on their loan (Fabozzi, 2007). Bhojraj and Sengupta (2003) calculate CoD using the bond yield of a company, while Fortin and Pittman (2003) using the ratio of interest expense to average interest bearing debt. Because not many companies in Indonesia that issued bonds, then the study will measure CoD using interest expense.

$$\frac{Interest\ expense}{Inteerst\ Bearing\ Debt}$$ Type equation here. (1)

Interest expense can be obtained from the company's income statement (Brigham, 2004). Interest bearing debt obtained by analyzing financial statements liabilities that contributed to the interest expense. Average Interest Bearing Debt is obtained from the average Interest Bearing Debt periods t and t-1.

Default risk is considered in the credit approval. One of the determinant variables in assessing default risk is GCG score due to it represents the performance of GCG implementation. Company which has a high GCG score is seen as a trusted company and assessed as a low default risk company. It will lead creditors to charge a low return from the company.

Blom & Schauten (2006) investigated the relationship between GCG and CoD using 300 samples from FTSE Eurotop 300. Bond yield is used to measure the CoD. The results showed that the better the GCG performance then the lower the CoD.

Anderson et.al (2003) also supported that CoD has a negative correlation with GCG practice. In their research, GCG practice was showed by the existence of independent board of commissioner, number of board commissioner and audit committee structure. GCG practices which assessed by authoritative party provide the creditor the assurance that the companies do not hide material information that potentially mislead in decision making. Then, companies which have good rating of their GCG practice will enjoy lower CoD. Therefore the hypothesis 1 proposed is :

H1: GCG score has a negative influence to the CoD.

According to previous researches, there are many other variables that affect CoD rate. Chen & Jian (2006) showed that debt to assets ratio (D/A) affect the CoD. The composition of debt to asset shows company assets protection to its creditor. The higher the debt to asset ratio, the higher the creditor claim to company's asset. Therefore, it will trigger potential conflict of interest between company and creditor (Ahmed, Billings, Morton, and Stanford & Harris, 2002). From the creditors' view, the higher D/A the higher the risk of the company, thus creditor will charge the higher CoD to compensate the risk. Anderson et.al (2003), using D/A as a control variable also found that there was a positive relationship between D/A and CoD. Using D/A as a control variable, the hypothesis 2, is proposed below :

H2 : D/A has a positive influence to the CoD

Low CoD rate will also be enjoyed by companies that have high return on assets (ROA) ratio. Since ROA indicate the capality of companies to create return from their assets, thus higher ROA means good performance of companies'operation. Creditor will appreciate company with higher ROA with lower CoD rate. Therefore ROA have a negative correlation to the CoD. This is supported by the research result of Chen & Jian (2006), Piot and Piera (2007) which prove that ROA have a negative affect to the CoD. Therefore hypothesis 3, is proposed as follow :

H3 : ROA has a negative affect to the CoD.

Firms with more growth opportunities will have lower leverage as the agency costs associated with the debtholder–stockholder conflict is likely to be a positive function for such firm (Kim & Lyn, 1986). According to (Myers, 1977), companies having better growth opportunities will have a tendency to finance their business with equity rather than debt. Using sales growth as a measurement of growth (Chen & Jian 2006), then the following hypothesis is proposed :

H4 : *Sales growth* has a negative affect to the CoD

Bhojraj & Sengupta (2003) suggest that big firms will obtain lower bond yield and higher bond rating due to their low market risk. Besides that, big firms have more resources to produce information disclosure that is more attractive to media and analyst (Chen & Jian 2006), since the company become more transparent than others. One of the firm size measurement is asset total. Company's asset owned shows the company'ability to repay its loan, thus credit risk for such a company should be low (Pittman & Fortin 2003). Anderson et al. (2003) proved that firm size has a negative correlation to CoD. Chen & Jian (2006), Piot & Piera (2007) also proved the same result. Therefore hipotheses 5 is proposed as follow:

H5 : Firm size has a negative affect to CoD.

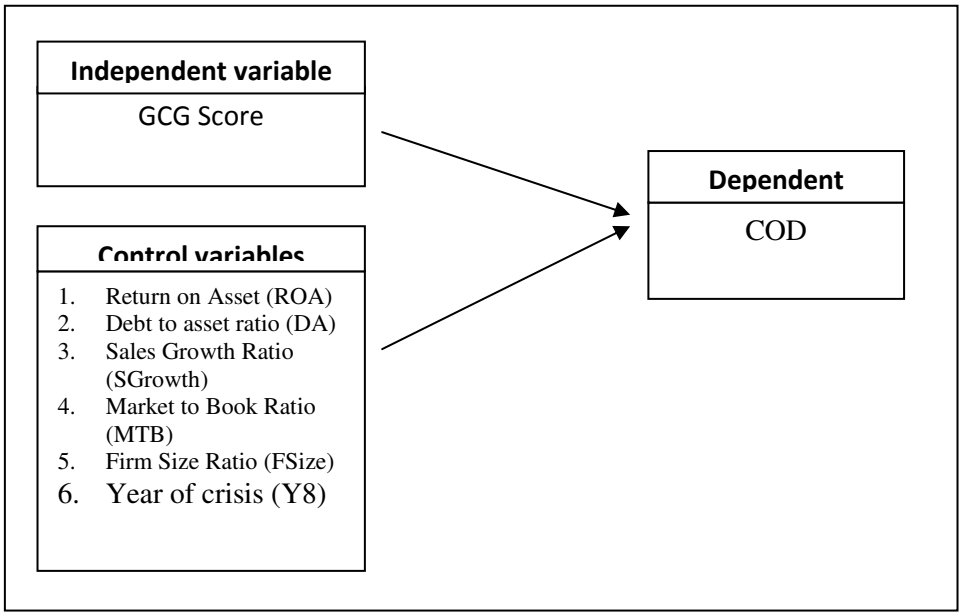
Binsbergen, Graham & Yang (2010) found that firms with growth opportunities that is low market-to-book (MTB) on average face a higher cost of debt. According to Myers (1977), growth firms have a higher cost of debt due to they use their assets to growth. On the other hand, debt forcing firms to comply covenant otherwise penalty will be imposed, this potentially resctricts the firms to exercise their assets to invest and growth. According to previous researches, hypothesis 6 is proposed as follow:

H6 : *Market to book ratio* a positive affect to CoD

3. Research Methods

To depict the relationship among variables to be tested, model analysis is presented in figure 2. To anticipate the effect of crisis period during 2007-2008, year of crisis added as a dummy variable in the following model.

Figure 2. Model Analysis



Regression equation formulated to test the hypothesis is as follow:

$$\mathbf{CoD = \beta_0 + \beta_1\ GCG + \beta_2\ ROA + \beta_3\ DA + \beta_4\ SGrowth + \beta_5\ MTB + \beta_6\ FSize + \beta_7\ Y8 + \mu} \quad (1)$$

whereas :

CoD	: Cost of Debt
β0	: constant
β1,2,3,4,5,6,7	: regression coefficient of each variable
GCG	: GCG Score
ROA	: Return on Asset
DA	: Debt to asset ratio
SGrowth	: Sales Growth
MTB	: Market to Book Ratio
FSize	: Firm Size
Y8	: Year of crisis (2007-2008)
μ	: *Error term*

Operationalization of each of variables is summarized in table 1 below:

Table 1 : Operationalisation of Variables

Symbol	Variables	Definition
CoD	Cost of Debt	$\frac{\text{Interest Expense}}{\text{Average Interst Bearing Note}}$ (1)
GCG	Good Corporate Governance	Score of GCG of each company (CGPI Index) based on IICG and SWA survey
ROA	Return on Asset	Net income divided by total assets
DA	Debt to asset ratio	Total debt divided by total asset
SGrowth	Sales Growth	Dirrefence of revenue year t toward revenue year t-1 divided by revenue year t
MTB	Market to Book Ratio	Market value of equity divided by book balue of equity
FSize	Firm size	Log of total asset
Y8	Dummy variable for the year of crisis (2007-2008)	One if data in the year of crisis (2007-2008) otherwise 2007-2008 equals zero

Accordance with the objective of this research, the sample used in this research limited to companies which participate in CGPI survey. Thus, these companies are as a unit analysis in this research. Purposive sampling technique is applied in this research. Sample is selected based on the following criteria : (1) participate in CGPI survey for the period 2004-2008, (2) has a thorough annual report for the priod 2005-2009, (3) not a banking or financial institution company, (4) publish GCG score.

4. Results and Discussions

There are 118 companies which participate in CGPI survey for the period 2004-2008 but remaining 38 companies meet with the sample criteria. Thoroughly selection process is presented in table 2.

Table 2. Sample Selection Process

Selection Criteria	Total
Number of companies participate in CGPI survey during 2004-2008	118
Less: bank and financial institution companies	(31)
Less: companies that do not have the complete annual report	(26)
Less: companies that do not publish GCG score	(23)
Total sample	**38**

Profile of research variables is shown in table 3. The average sample has a relatively high GCG score of 75.46, can be classified as 'trusted'. Maximum cost of debt is 15.8 % with average 10.62% , this rate is quite competitive compared with 7.08% ROA . On average, sample firms have a quite homogen size as shown by a narrow range between the minimum and maximum value of each variable.

Table 3. Descriptive Statistic

Descriptive Statistics

	N	Minimum	Maximum	Mean	Std. Deviation	Variance
COST OF DEBT	38	.058	.158	.10621	.026742	.001
GCG SCORE	38	56.38	87.40	75.4574	7.27448	52.918
DEBT TO ASSET	38	.176	.883	.48868	.178145	.032
RETURN ON ASSET	38	-.617	.426	.07084	.139498	.019
SALES GROWTH	38	-2.270	14.182	.53737	2.347144	5.509
FIRM SIZE	38	5.122	7.914	6.69155	.655857	.430
MARKET TO BOOK	38	.63	7.22	2.2150	1.60753	2.584
YEAR 2008	38	.00	1.00	.3158	.47107	.222
Valid N (listwise)	38					

Before testing hypothesis, data need to be tested whether it meet with the classical assumption or not. With a confidence level of 5%, model meets the normality test, autocorrelation, heteroskedasticity and multicolinierity. Kolmogorov-Smirnov is used to test normality. The residual value is 0.974 greater than 0.05, it means that data are normally distributed. Heteroskedasticity test using the White test. Due to the probability of Obs*R-squared is 0.6203 (exceeding 0.05), it can be concluded that heteroskedasticity problem does not exist. Autocorrelation test is performed by the method of Breusch-Godfrey. Result the probability of Obs * R-squared is 0.2985 (exceeding 0.05), it can be concluded that there was no autocorrelation problem. Multicollinearity test can be seen from the VIF value. VIF value for all independent variables data below 10 and tolerance values above 0.1 means that all variables are free from multicollinearity. Tables containing the classical assumption test results are presented in annex 1.

Model summary with R value of 0.571 shows a fairly strong relationship of CoD with all indepennt variables. While R square is 0.326 means that 32.6% of change in CoD can be explained by GCG *Score*, ROA, D/A, SGrowth, FSize, MTB, and Y8, as shown in table 4. But the significance of independent variables in explaining the change of independent variable is not good enough, because the value of F sig is 0.078 greater than 0.05 (see table 5), however this model is still quite fit on the significance of 10%.

Table 4. R Value, R Square, SEE

Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.571[a]	.326	.169	.024380

a. Predictors: (Constant), YEAR 2008, FIRM SIZE, SALES GROWTH, DEBT TO ASSET, RETURN ON ASSET, GCG SCORE, MARKET TO BOOK

Table 5. F Test and Significance

ANOVA[b]

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	.009	7	.001	2.074	.078[a]
	Residual	.018	30	.001		
	Total	.026	37			

a. Predictors: (Constant), YEAR 2008, FIRM SIZE, SALES GROWTH, DEBT TO ASSET, RETURN ON ASSET, GCG SCORE, MARKET TO BOOK

b. Dependent Variable: COST OF DEBT

Results of regression test as presented in table 6 below is used to test each hypothesis.

Table 6. Constant, Coefficients, T Test and Sig

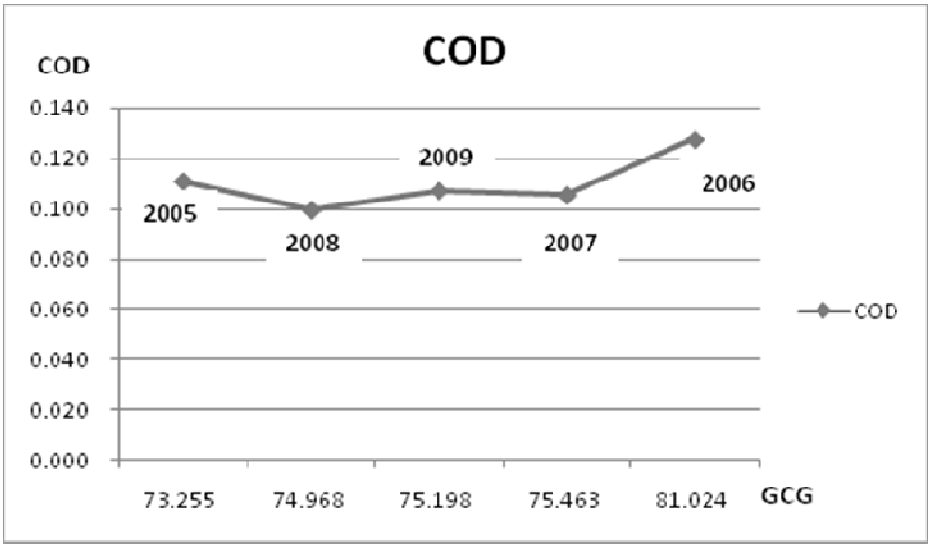
Coefficients[a]

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	.221	.050		4.406	.000
	GCG SCORE	.001	.001	.178	.981	.335
	DEBT TO ASSET	.030	.026	.197	1.133	.266
	RETURN ON ASSET	-.040	.036	-.207	-1.111	.275
	SALES GROWTH	-.001	.002	-.108	-.712	.482
	FIRM SIZE	-.027	.008	-.673	-3.472	.002
	MARKET TO BOOK	.005	.004	.290	1.294	.205
	YEAR 2008	-.007	.010	-.130	-.734	.469

a. Dependent Variable: COST OF DEBT

The significance value of GCG score is 0.335 greater than 0.05 means that there is no significant affect of GCG score to the CoD. The result do not support hypothesis 1 and contrarary with some previous research results by Blom & Schauten (2006) also Anderson et.al (2003).

Figure 3. Profile of GCG and COD



The research sample data, as presented in figure 3 show that the increasing or decreasing of CoD has no similar pattern with the raising and falling of GCG score. It seem that creditors ignore the company's GCG score in determining cost of debt. GCG score is not credible enough to creditor to justify the company's risk. The fact that company which actively involved in GCG survey do not guarantee to be free from default. Bakrie Group for example, as one of the active participant in GCG survey, surprisingly had defaulted on their loans. It has been decreased the credibility of the GCG score as a representative tool to evaluate company risk.

As a new practice to evaluate GCG implementation, the GCG survey is still need times to prove as a credible indicator to be considered in assessing company risk. The participation in GCG survey has not been mandatory yet, thefore the number of participant tend to be decline from year to year. This raises further doubt of creditor to use GCG score as one of the indicators in assessing the required return. Moreover, Setyaningrum (2005) stated that although the company has good corporate governance, it does not guarantee high debt ratings due to there are other factors outside of corporate governance should be considered, such as political factors, industry risk, the company's position in the economy, including the market sentiment and rumors.

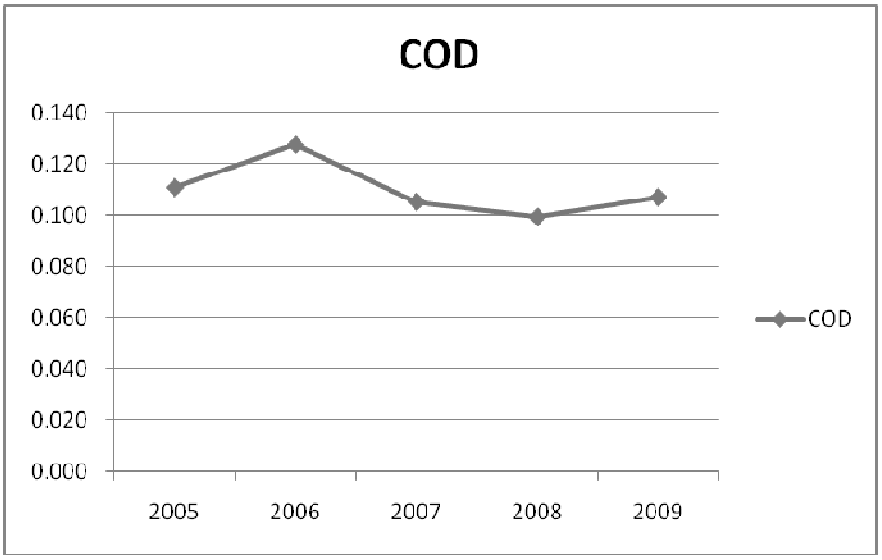
Further, the result of testing hypothesis 2 is also do not supported. The result shows that D/A *Ratio* do not significantly affect to the COD. It is contrary with the previous results as evidenced by Chen & Jian (2006), Piot and Piera (2007). Mahadwartha & Ismiyanti (2007) insist that creditor perceives fixed assets as a collateral not share of claim with investors, therefore D/A is not a significant variable. The results of testing hypothesis 3 and 4 which stated that ROA, SGrowth have a significant affect to the CoD are also not proven. Bharath (2008) states that lending to the old lender usually require lower security (collateral) than collateral to the new lender, this will produce a more favorable loan agreements for the company. It imply that creditor pay more attention on the lender's credit history rather than just financial ratio such as D / A, ROA, and SGrowth in determining required return.

Contrary with the results of hypothesis testing toward the financial ratio, Fsize on the other side proves the negative significant affect to the CoD. Therefore hypothesis 5 is accepted. This result is consistent with Anderson et al. (2003), Chen & Jian (2006), and Piot & Piera (2007). Creditor tend to trust a company that owns a large amount of assets or big company. This company is perceived more open in providing information than small company. It will reduce information assymetri and reduce risk. Creditor will expect low return for such company.

Market to Book has significant affect to the CoD as hypothesized in hypothesis 6, however the result do not support this hypothesis. This is inconsistent with the previous research (Chen & Jian 2006). It seems that ratio market to book has no information content to the creditor in assessing company's risk. Creditors do not confidence that market is representation of firm performance. There are many factors outside company controls influence market value of book assets. That is why creditors do not rely on their decision on the market to book assets.

To prove the impact year of crisis to CoD, this research use year of crisis (Y8) as a dummy variable. The hypothesis testing do not confirm the significance relationship of year of crisis to the CoD. Apparently the creditor is not affected by the crisis situation in requiring return. Therefore hypothesis 7 is rejected. Research sample data also shows that interest expense is relatively stable during the period of crisis as indicated in figure 4. The short-term period of crisis may be deemed quite safe by creditor not to raise their required return. Beside that cost of debt has already been contained in debt covenant and valid for certain period.

Figure 4. Cost of Debt Profile



5. Conclusion and Limitation

This research cannot prove the existing relationship of GCG implementation proxied by GCG score to the CoD. However it is too early to conclude that there is no benefit of GCG implementation to companies.

Some explanations are as follows, firstly, GCG survey is new practice therefore need more time to make users convince with the result. Secondly, the GCG survey is not mandatory, only a few companies participate in this survey. Thirdly, Some companies still can not see the benefit to participate in the GCG survey even costly. While the fourth and the fith explanations are there is no guarantee that firm with high GCG score is free from default risk, and aspects used to measure GCG implementation are still vary, it make companies and users (creditors) confuse with its results.

Further, the results of variable control testing show that only Fsize has a strong affect to the CoD, while other five variables such as D/A, ROA, SGrowth MTB, Y8 have no affect to the CoD. However all the variables have the explanation value in changes of CoD, using 10% confidence level.

Since GCG score is one of the proxies of GCG implementation, it give an opportunity for future research to use another measurement of GCG implementation, so the robustness problem in this current research could be fixed. Extended the sample period is also another opportunity for future research to improve the current result and to closeness the results with the real fact.

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Appendix 1 : Classical Assumption Test

Table 1 . Normality Test

One-Sample Kolmogorov-Smirnov Test

		Unstandardized Residual
N		38
Normal Parameters [a,b]	Mean	.0000000
	Std. Deviation	.02195295
Most Extreme Differences	Absolute	.078
	Positive	.078
	Negative	-.045
Kolmogorov-Smirnov Z		.483
Asymp. Sig. (2-tailed)		.974

a. Test distribution is Normal.

b. Calculated from data.

Table 2. Heteroskedasticity

Heteroskedasticity Test: White

F-statistic	0.628248	Prob. F(28,9)	0.8339
Obs*R-squared	25.13848	Prob. Chi-Square(28)	0.6203
Scaled explained SS	10.68124	Prob. Chi-Square(28)	0.9987

Table 3. Autocorrelatin Test

Breusch-Godfrey Serial Correlation LM Test:

F-statistic	0.953810	Prob. F(1,30)	0.3366
Obs*R-squared	1.080816	Prob. Chi-Square(1)	0.2985

Table 4. Multicollinearity Test

Coefficients[a]

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.	Collinearity Statistics	
		B	Std. Error	Beta			Tolerance	VIF
1	(Constant)	.221	.050		4.406	.000		
	GCG SCORE	.001	.001	.178	.981	.335	.683	1.465
	DEBT TO ASSET	.030	.026	.197	1.133	.266	.746	1.341
	RETURN ON ASSET	-.040	.036	-.207	-1.111	.275	.645	1.549
	SALES GROWTH	-.001	.002	-.108	-.712	.482	.973	1.028
	FIRM SIZE	-.027	.008	-.673	-3.472	.002	.599	1.671
	MARKET TO BOOK	.005	.004	.290	1.294	.205	.448	2.232
	YEAR 2008	-.007	.010	-.130	-.734	.469	.714	1.401

a. Dependent Variable: COST OF DEBT