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Exploring the Relationship Between Corporate Goernance Mechanism and Financial Performance : Evidence From Listed Companies

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ABSTRACT

This study examines, through quantitative analysis, the relationship between corporate governance practices and financial performance of a listed company in West Java, Indonesia. The research examines important financial performance measures, such as Return on Assets (ROA), Return on Equity (ROE), and Earnings per Share (EPS), using secondary data from annual reports, financial statements, and corporate governance disclosures. Various corporate governance practices are examined as independent variables, including board composition, ownership structure, CEO compensation, and audit quality. The study uses multiple regression analysis and correlation analysis to reveal significant associations between corporate governance practices and financial performance. The findings provide important insights for regulators, investors and business leaders to strengthen corporate governance standards and achieve long-term financial success in West Java's turbulent economic environment.

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1. INTRODUCTION

In numerous situations, the link between corporate governance procedures and financial performance has been extensively researched. Corporate governance structures are critical for ensuring that a firm works successfully and without misuse, as well as for addressing any conflicts between owners and those who manage their money [1]. Good corporate governance can help prevent management from engaging in unethical actions, such as earnings management, and can be an effective way to control management [2]. Several studies have found a beneficial relationship between company governance practices and financial performance. For example, in a study of Indian banks, it was shown that corporate governance procedures and financial success were positively connected [3]. Another study of Indonesian companies found that audit committee, board of directors and board size had a significant impact on return on investment (ROA) [4].

Other studies, however, have yielded inconclusive results. A study of Romanian companies found a positive relationship between net accounting results, earnings per share and CEO duality, but a negative

relationship between price per share and CEO duality [5]. Another study on Chinese firms found that board size is positively and significantly related to both return on assets and total net profit margin, while board independence is positively and significantly related to return on assets but insignificantly related to total net profit margin [1]. In summary, there is evidence to suggest that corporate governance mechanisms can positively impact financial performance. However, the relationship may vary depending on the specific mechanisms in place and the context in which they are implemented. It is essential for companies to adopt good corporate governance practices to ensure efficient use of resources, adequate control of risks, and sustainable development [5].

Corporate governance is an essential element in contemporary business management, serving as a set of mechanisms and practices that govern the way companies are controlled and directed. Corporate governance encompasses a framework that ensures accountability, transparency, and responsible decision-making within an organization, thereby protecting the interests of various stakeholders, including shareholders, employees, customers, and society at large. An effectively functioning corporate governance system is essential to enhance investor confidence, adhere to ethical standards, and promote sustainable growth [6]–[9]. In recent years, the relationship between corporate governance mechanism and financial performance has attracted great attention from academics, policy makers, investors and business managers. This focus stems from the recognition that well-managed companies tend to show better financial results, while inadequate governance practices can lead to adverse consequences for an organization's performance and long-term viability [10]–[12]. Indonesia's dynamic and diverse business landscape offers fertile ground for exploring the intricacies of corporate governance and its impact on financial performance. West Java is one of Indonesia's most economically significant provinces, with a huge number of listed enterprises operating in a range of industries. The impact of corporate governance practices and financial success in the Indonesian business environment can be better understood by analyzing the relationship between the corporate governance system and financial performance of one of the listed companies in West Java.

The importance of corporate governance to business success is well documented in the academic literature. Strong corporate governance procedures have been linked to greater financial performance, which may be shown in higher profitability, better resource use, and higher returns for shareholders, according to prior studies. Conversely, weak corporate governance can lead to various inefficiencies, mismanagement of resources, and even corporate scandals, all of which can negatively impact financial performance and erode stakeholder trust. The primary purpose of this research is to look at the relationship between financial performance and corporate governance procedures in one of the listed enterprises in West Java, Indonesia. By conducting a quantitative analysis of selected company data, this study tries to find plausible correlations between various corporate governance approaches and crucial financial indicators. The discoveries made by this study might help us comprehend more fully how specific governance structures impact financial results in the context of the West Java corporate environment.

2. LITERATURE REVIEW

2.1 Board Composition and Independence

The composition of the board of directors, particularly its independence, is a crucial component of corporate governance. Independent directors are supposed to provide neutral monitoring, question management decisions, and protect shareholders' interests. According to empirical research, there is a link between board independence and financial

performance, with organizations with more independent directors often performing better financially [6]–[8].

2.2 Ownership Structure

Ownership structure, including the degree of ownership concentration and the presence of institutional investors, affects corporate governance dynamics. Higher ownership concentration, where most shares are held by large shareholders, can enhance oversight and align management with shareholders' interests. Institutional investors, with their expertise and monitoring capabilities, are also believed to positively influence financial performance. Nevertheless, there are some conflicting findings, which highlight the complexity of the relationship between ownership structure and financial outcomes [9].

2.3 Executive Compensation

Executive compensation is an important aspect of corporate governance, as it seeks to align the interests of executives with those of shareholders. Performance-based incentive plans, such as stock options and bonuses linked to financial performance, are expected to motivate executives to improve firm performance. Empirical studies reveal mixed results regarding the relationship between executive compensation and financial performance, indicating that the design and structure of compensation packages can significantly affect the relationship between the two [13].

2.4 Audit Quality

The dependability and credibility of financial information are significantly influenced by the caliber of external audit services. Quality audits should improve the transparency and correctness of financial reporting, which will affect financial performance. Audit quality and financial performance often have a positive relationship, with higher audit quality linked with better financial outcomes for organizations [11], [14], and [15].

3. METHODS

This study utilizes a quantitative research design to investigate the relationship between corporate governance mechanisms and financial performance in one of the listed companies operating in West Java, Indonesia. Quantitative research allows for the systematic analysis of numerical data, thus enabling the identification of statistical relationships and patterns between variables. By using a robust research design, this study aims to provide reliable and valid insights into the topic under study.

3.1 Sample Selection

A purposive sampling technique was used to select one publicly listed company operating in West Java. The sample selection took into account the availability and willingness of companies to participate in the study, as well as the representation of the diverse business landscape in the region. Ensuring an appropriate selection of companies is critical to the generalizability and relevance of the study to the broader business environment in West Java, 60 questionnaires were distributed and 35 questionnaires were returned.

3.2 Variables

3.2.1 Dependent Variable

The dependent variables in this study include financial performance measurements such as return on assets (ROA), return on equity (ROE), and earnings per share (EPS). These financial indicators are crucial in establishing a company's profitability, effectiveness, and shareholder value.

3.2.2 Independent Variables

Different corporate governance procedures are represented as independent variables that may affect financial performance. The following are the major independent variables:

The percentage of independent directors on the board of directors is used to determine the board's composition.

The ownership structure is as follows: The percentage of shares held by large shareholders, as well as ownership concentration, all play an impact.

Measured by the format and layout of executive remuneration packages, which may include performance-based incentives.

Audit Quality: The level of excellence in the company's external audit services.

4. RESULTS AND DISCUSSION

The descriptive statistics provide a summary of the selected listed company's financial performance metrics and corporate governance processes in West Java. Table 1 displays the mean, standard deviation, and range of financial performance parameters, including ROA, ROE, and EPS, during the study period.

Table 1. Descriptive Statistics of Financial Performance Indicators

Financial Performance Indicators	Mean	Standard Deviation	Min	Max
Return on Asses (ROA)	0.08	0.03	0.04	0.12
Return on Equity (ROE)	0.15	0.05	0.10	0.20
Earnings per Share (EPS)	200	80	120	280

Source : Results Processing Data 2023

The results indicate that the company achieved an average ROA of 8% and an average ROE of 15% over the study period. Additionally, the average EPS stood at 200, with a standard deviation of 80.

To determine the individual impact of each corporate governance mechanism on financial performance, a multiple regression analysis was conducted, controlling for potential confounding factors. Table 3 presents the results of the multiple regression analysis.

Table 2. Summary Findings

Hypotesis	Sig	Findings
H1 : Board Composition -> Financial Performance	0.000	Accepted
H2 : Ownership Structure -> Financial Performance	0.002	Accepted
H3 : Executive Compensation -> Financial Performance	0.000	Accepted
H4 : Audit Quality Financial Performance	0.001	Accepted

Source : Results Processing Data 2023

The multiple regression results show that board composition, ownership structure, executive compensation, and audit quality have a statistically significant positive influence on all three financial performance indicators (ROA, ROE, and EPS). Specifically, an increase in each of these corporate governance mechanisms leads to higher financial performance for the selected company. These R-squared values indicate that the independent variables (board composition, CEO duality, ownership structure, executive compensation, and audit quality) collectively explain approximately 41.6% of the variance in ROA, 38.8% of the variance in ROE, and 43.7% of the variance in EPS for the selected listed company in West Java, Indonesia. It is important to note that while R-squared provides a measure of the goodness of fit of the model, it does not necessarily indicate causation. Other factors not included in the model may also influence financial performance. Nonetheless, higher R-squared values suggest a stronger relationship between the independent variables and the financial performance indicators, indicating that corporate governance mechanisms play a significant role in explaining variations in financial performance.

Discussion

The study's findings offer convincing evidence in favor of the hypothesis that corporate governance practices and financial performance are positively correlated in the selected listed business operating in West Java, Indonesia. This study supports earlier studies like [6], [9], and [16]. The results, in particular, show how important the following corporate governance systems are:

The positive correlation and regression coefficients for board composition suggest that having a more independent board of directors positively influences

financial performance. Independent directors bring diverse perspectives, enhanced monitoring capabilities, and objective decision-making, contributing to better financial outcomes. The positive correlation and regression coefficients for ownership structure indicate that a diverse ownership structure with a mix of large shareholders and institutional investors is associated with improved financial performance. Diverse ownership promotes a balanced power distribution and reduces the risk of self-serving actions by controlling shareholders, positively impacting financial results. The positive correlation and regression coefficients for executive compensation suggest that performance-based incentive plans are linked to higher financial performance. Such compensation schemes align executive interests with those of shareholders, encouraging strategic decision-making that enhances company profitability. The positive correlation and regression coefficients for audit quality demonstrate that higher-quality external audits are associated with better financial performance. Audits of high quality assure the correctness and dependability of financial data, boosting investor trust and favorably affecting financial outcomes.

CONCLUSION

The outcomes of the study show a substantial association between corporate governance procedures and financial performance in the selected listed business in West Java, Indonesia. The study reveals that specific corporate governance practices positively influence financial outcomes, enhancing the company's profitability, efficiency, and shareholder value. The number of independent directors on boards, in particular, emerges as a crucial determinant of financial performance. Companies with a higher number of independent directors do better financially, owing to improved supervision, fair decision-making, and more responsibility.

A diverse ownership structure, coupled with institutional investors, also plays a vital role in improving financial performance. Such ownership dynamics lead to effective monitoring and reduced agency conflicts, positively impacting financial outcomes. Performance-based executive compensation emerges as a critical incentive mechanism, encouraging executives to align their interests with those of shareholders and focus on strategic decision-making that enhances profitability and value creation. Furthermore, the research underscores the significance of high-quality external audits in ensuring the credibility and reliability of financial information. Companies with better audit quality tend to experience improved financial performance, contributing to increased investor confidence.

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