Impact of Selected Factors Towards Shareholder Value Creation

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Abstract. The purpose of this research was to obtain empirical evidence about the effect of capital structure, Good Corporate Governance, Free Cash Flow, and audit quality towards shareholder value creation. The sample in this research was selected by using purposive sampling. The secondary data were analyzed by using multiple linear regression method. The total amount of sample in this research were 9 companies in trade, service, and investment sector. The results of this research were that capital structure had no negative effect towards shareholder value creation, board size had significant negative effect towards shareholder value creation, commissioner independence and audit quality had no positive effect towards shareholder value creation, and FCF had significant positive effect towards shareholder value creation. The implication of this research was that company needed to maintain an adequate level of free cash flows in order to be able to pay debt, reduce invested capital, and increase EVA.

Keywords: audit quality, capital structure, Economic Value Added, Free Cash Flow, Good Corporate Governance, shareholder value creation.

1 Introduction

Indonesia is a developing country with great economic potential. The investment climate in Indonesia is getting better, as evidenced by the Jakarta Composite Index (JCI) which has increased over the last 10 years. At the end of 2009, the JCI was at the level of 2,534.36. At the end of 2019, the JCI was at the level of 6,299.54. This means that the JCI has increased by 148.6% in the 10-year period. One sector that is quite attractive in the Indonesian capital market is the trade, services and investment sector. It is known that in the last 10 years, the IDX Trade, Services and Investment Index has increased by 179.2%. Companies in this sector are suspected of having an advantage in terms of the ability to produce operational performance that exceeds performance expectations measured by cost of capital so that it reflects the creation of shareholder value in companies in this sector. One example of the importance of shareholder value creation is shown by PT Ace Hardware Indonesia Tbk (ACES) which is include in the trade sector. At the end of 2015, the closing price of ACES shares was Rp825 per share. Meanwhile, at the end of 2019, the company's share price had increased to Rp1,495 per share. The company's share price increased by 81.2% during 2016-2019, much higher than the 37.2% increase in the JCI in the same period. The increase in the company's stock price reflects the high interest of investors to invest by buying company shares. One of the factors that attract investors to invest is the company's EVA value which is always positive in the 2016-2019 period. Investors in the capital market also think that ACES shares deserve to be valued above their book value. This is reflected in the market to book ratio of 5.72 times. This means that investors in the capital market value the company much higher than the company's book value, which is 5.72 times the company's book value.

According to Suripto [1], companies need to pay attention to things that can affect the creation of value for shareholders so that companies can generate net operating profit after tax that exceeds the cost of capital. When the net operating profit after tax generated exceeds the

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cost of capital, this condition is referred to as shareholder value creation. According to Sharma and Grover [2], shareholder value creation is the return generated by the company above the cost of capital. Shareholder value creation can be measured using the Economic Value Added (EVA) method. Sabol and Sverer [3] defines EVA as the difference between the profit earned from operating activities and the cost of the capital used.

Various factors are estimated to affect shareholder value creation. Factors that are expected to affect shareholder value creation include capital structure. According to Subramanyam [4], capital structure is company funding in the form of equity and debt which is often measured in terms of the relative size of various funding sources. Capital structure is measured by DER. A low DER indicates a relatively low use of debt compared to equity. Thus, the company has adequate financial flexibility to expand which can increase the company's Earnings Before Interest and Tax (EBIT) so as to produce a higher Net Operating Profit After Tax (NOPAT) value. If the increase in NOPAT is accompanied by an optimal cost of capital, it will affect the increase in EVA. According to Marouan and Moez [5],board size is expressed as the number of directors in the company. An increase in the number of the board of directors can encourage an increase in financial performance resulting in an increase in NOPAT and decrease of capital charges that will increase in EVA. According to Financial Services Authority Regulation (POJK) Number 33/POJK.04/2014, the board of commissioners consists of at least 2 members of the board of commissioners and the number of independent commissioners must be at least 30% of the total members of the board of commissioners. A high level of independence in the board of commissioners can increase transparency which will reduce information asymmetry between investors and management. This affects the decrease in the cost of equity capital borne by the company. With an increase in the company's operational performance as reflected in the amount of NOPAT and accompanied by a decrease in capital charges, this will have an effect on increasing EVA. Free Cash Flow (FCF) is the amount of cash flow that can be used freely based on company policy to buy additional investments, pay off debt, buy treasury shares, or increase liquidity [6]. A high FCF indicates the company has sufficient cash flow to continue its operational activities without requiring additional external funding [7]. This will reduce the amount of invested capital both from debt and equity so that capital charges are lower. Accompanied by optimal operational performance, reflected in the amount of NOPAT, a decrease in capital charges will affect the increase in EVA value as a measure of shareholder value creation.

Decision making by stakeholders requires a series of assessments and evaluations of company-related information, which can be found in audited financial statements. In conducting the audit process, the auditor must follow the Professional Standards of Public Accountants [8]. Companies that choose Big 4 KAPs that have a good reputation and this is seen as a positive thing for creditors because the company is considered more transparent, and has good quality financial reports, so that the company's risk is lower [9]. Lower risk can increase the interest of fund providers to provide funding for companies and decrease WACC so that it can reduce the company's capital charges. Accompanied by optimal operational performance, reflected in the amount of NOPAT gains, this decrease in capital charges will have an effect on increasing EVA value.

2 Literature Review

The theory used in this research is signal theory. The signal theory perspective emphasizes that companies can increase company value by giving signals to investors through reporting information related to company performance so that they can provide an overview of future business prospects. The higher the profitability number listed in the financial statements, the better the company's financial performance, it will reflect the greater wealth of investors and the company's prospects in the future are considered more promising [10]. The dependent variable studied is shareholder value creation. Shareholder value creation is the return generated by the company above the cost of capital [2]. A company should be considered successful only if the return generated is better than the level of return expected to be received by investors in the capital market [11]. To create value for shareholders, companies must generate returns on invested capital that exceed the cost of capital [12]. Shareholder value creation can be measured using the EVA method [2].

Capital structure is the company's funding in the form of equity (equity) and debt (debt) which is often measured in terms of the relative size of various funding sources (Subramanyam, 2014). According to Sharma and Grover [2], capital structure can be determined with the help of the Debt-Equity Ratio (DER). DER is calculated by dividing total liabilities by total shareholder equity [4]. Liabilities are defined as creditors' rights to total assets and as existing debts and liabilities [13]. Equity is the residual interest in the entity's assets after deducting all liabilities [14]. Research by Sharma and Grover [2] and Wijanti *et al*. [15] shows that DER has a significant negative effect on EVA. Board size is expressed as the number of directors in the company [5]. According to Law (UU) Number 40 of 2007 concerning Limited Liability Companies, the board of directors is a company organ that is authorized and fully responsible for managing the company for the benefit of the company, in accordance with the aims and objectives of the company and representing the company, both inside and outside the court in accordance with the law. With the provisions of the articles of association. Research by Kabir *et al* [16] and Tariq and Naveed [17] shows that board size has a significant positive effect on EVA. This is different from the research of Nnado and Ugwu [18] which shows that board size has a significant negative effect on EVA. According to Law Number 40 of 2007, independent commissioners are appointed based on the decision of the GMS from parties who are not affiliated with the major shareholders, members of the board of directors and/or other members of the board of commissioners. The results of Kabir *et al*'s [16] research show that board independence has a significant positive effect on EVA.

Free Cash Flow (FCF) measures the operating cash flow available to the company after purchasing the property, plant, and equipment needed to maintain current operations [7]. In other words, company management has the freedom to use Free Cash Flow funds because all funding needs for profitable operations and investments have been fulfilled [19]. The results of [20] research show that the Free Cash Flow (FCF) variable has a significant positive effect on EVA. On the other hand, the research results of Wijanti *et al*. [15] show that FCF has no significant effect on EVA. Audit quality can be said as a possibility that may occur, when an auditor audits the financial statements of a client, the auditor can see or find errors and also a violation that occurs in the client's accounting system. The audit results from KAP Big 4 are considered quality because they meet these factors [9]. The results of Hatane *et al*.'s [21] research show that audit quality has a significant positive effect on EVA in Malaysian companies.

Based on the description above, the hypotheses in this study are as follows:

Ha_1: Capital structure proxied by Debt-Equity Ratio (DER) has a negative effect on shareholder value creation as proxied by Economic Value Added (EVA).

Ha_2: Good Corporate Governance proxied by board size has a positive effect on shareholder value creation as proxied by Economic Value Added (EVA).

Ha_3: Good Corporate Governance proxied by commissioner independence has a positive effect on shareholder value creation as proxied by Economic Value Added (EVA).

Ha_4: Free Cash Flow has a positive effect on shareholder value creation as proxied by

Economic Value Added (EVA).

Ha_5: Audit quality as proxied by KAP size (Big Four and non-Big Four) has a positive effect on shareholder value creation as proxied by Economic Value Added (EVA).

The research model used in this study is as follows:

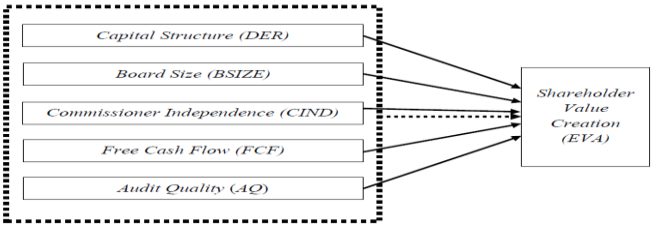

Fig. 1. Research Model

3 Methodology and Data Analysis

The research method used in this study is a causal study. A causal study is a research study conducted to prove a cause and effect relationship between variables [22]. The following are the measurements of the variables in this study:

Table 1. Variable Operational Measurement

Variable	Formula	Source
Dependent	*EVA = NOPAT – Capital Charges*	[12]
Independents	$DER = \frac{\textit{Total liabilities}}{\textit{Shareholder's equity}}$	[4]
	Board size = jumlah anggota dewan direksi	[23]
	$CIND = \frac{\text{Jumlah dewan komisaris independen}}{\text{Jumlah total anggota dewan komisaris}}$	[24]
	FCF = Cash flows from operating activities - Cash used to purchase PP&E	[7]
	Audit quality = Dummy 1 for Big 4, 0 for non-Big 4	[21]

The data used in this research is secondary data. In this study, the sample was selected using purposive sampling method. The criteria used in this research were companies which have been listed on Indonesia Stock Exchange (IDX) simultaneously for the year 2016-2019, not included in investment company subsector, published annual reports and/or annual financial statements that ended in December, using Rupiah, and have been audited by independent auditor, did not do share split or reverse share split, had listed their shares to be traded on IDX since the beginning of the research year, had interest-bearing debt balance on the beginning and/or end of the year and reported the amount of interest expense in the financial statements, generated positive Net Operating Profit After Tax (NOPAT), and had positive Free Cash Flow during the period of the research. The data analysis method in this study uses multiple linear regression with the help of data processing using SPSS (Statistical Product and Service Solutions).

4 Research Result and Discussion

The data in this study have passed the normality test and the classical assumption test. The value of the correlation coefficient (R) in this study was 0.867 or 86.7%, which shows high (strong) correlation. Adjusted R Square value in this study is 0.702, which shows that the independent variables in this study can explain the variation of shareholder value creation of 70.2% and the remaining 29.8 % is explained by other variables not tested in this study.

The results of the F statistical test show the F value of 15.115 with a significance value of 0.000, therefore it can be concluded that the independent variables simultaneously have a significant effect on the dependent variable. This shows that the sample regression function in estimating the actual value is correct or the model fits.

Table 2. Results of Statistical Test-t

Coefficients[a]

Model		Unstandardized Coefficients B	Unstandardized Coefficients Std. Error	Standardized Coefficients Beta	t	Sig.
1	(Constant)	1.133E+12	8.374E+11		1.353	.188
	DER	-3.598E+10	1.051E+11	-.037	-.342	.735
	SQRT_BSIZE	-5.845E+11	2.698E+11	-.368	-2.167	.040
	SQRT_CIND	-2.931E+11	8.573E+11	-.037	-.342	.735
	SQRT_FCF	1013322.862	148375.822	1.063	6.829	.000
	AQ	1.312E+11	1.102E+11	.134	1.191	.245

a. Dependent Variable: EVA

Based on Table 2, the regression equations in this study were obtained, as follows:

$$EVA = -0{,}037DER - 0{,}368BSIZE - 0{,}037CIND + 1{,}063FCF + 0{,}134AQ$$

Based on Table 2, Ha_1 is rejected, which means that the capital structure as proxied by DER does not have a negative effect on shareholder value creation as proxied by EVA. A total of 25 out of 36 observations had a DER value below the average (0.9168). 22 of the 25 observations had an increasing fixed asset balance. The expansion carried out by the company caused NOPAT 12 observations which tended to increase by an average of 22.2% and invested capital which increased with an average increase of 12.92%. Thus, the low DER value which allows the company to expand so as to increase NOPAT does not necessarily make the company produce a higher EVA value. Companies also need to reduce capital charges through efficient management of funding costs in order to increase EVA.

In this study, Ha_2 is rejected so that Good Corporate Governance as proxied by board size has a significant negative effect on shareholder value creation as proxied by EVA. This is in line with the research of Nnado and Ugwu [18] which shows that board size has a significant negative effect on EVA. Based on research data, observations with a large board size tend to have a higher WACC with an average of 9.70% compared to observations with small board size with an average WACC of 8.18%, where observations with a large board size have increasing capital charges and resulted in the decreasing value of EVA. Thus, board size tends to have a negative effect on EVA.

Ha_3 is rejected, which means that Good Corporate Governance as proxied by commissioner independence does not have a positive effect on shareholder value creation as proxied by EVA. This is different from the results of research by Kabir *et al*. [16] which showed that board independence had a significant positive effect on EVA. The ineffectiveness of commissioner independence on EVA may be due to the fact that the majority of observations in this study have low commissioner independence, so that the assumption arises that the appointment of independent commissioners is more aimed at fulfilling the provisions related to the composition of independent commissioners in the board of commissioners of at least 30% of the total number of regulated members of the board of commissioners. Independent commissioners are also considered to have no significant contribution to operational performance. A lower cost of capital but not accompanied by optimal operational performance also causes commissioner independence to have no significant effect on shareholder value creation.

Ha_4 is accepted which means that Free Cash Flow (FCF) has a positive and significant effect on shareholder value creation as proxied by EVA. This is in line with the research [20] which shows that Free Cash Flow has a significant positive effect on EVA. However, this is different from the research results of Wijanti *et al*. [15] which showed that Free Cash Flow had no significant effect on EVA.

Ha_5 is rejected, which means that audit quality as proxied by KAP size (Big Four and non-Big Four) does not have a positive effect on shareholder value creation as proxied by EVA. This is different from the research results of Hatane *et al*. [21] which showed that audit quality had a significant positive effect on EVA. The data shows that the observations audited by the Big Four KAPs on average have a higher WACC, with an average of 9.47%, compared to observations audited by non-Big Four KAPs with an average WACC of 8.24 %. Capital charges on observations audited by Big Four KAPs increased higher than observations audited by non-Big Four KAPs, namely 7.13% compared to 6.33%. Thus, audit quality as proxied by KAP size has no significant effect on shareholder value creation as proxied by EVA.

5 Implication and Suggestion for Future Research

The conclusion obtained from the results of this study is that only Ha_4 is accepted, which means that Free Cash Flow has a significant positive effect on shareholder value creation as proxied by EVA, as evidenced by the t value of 6.829 with a significance level of 0.000. In this study, Free Cash Flow proved to have a positive effect on shareholder value creation. Companies need to strive for adequate cash flow in order to increase EVA.

The limitation of this research is that the research object is only trade, service, and investment sector companies listed on the IDX for 2016-2019 so that the results of this study cannot be generalized to all companies listed on the IDX and the value of Adjusted R Square in this study amounted to only 0.702. Based on the conclusions and limitations, suggestions that can be given to further researchers related to shareholder value creation is to expand the object of research by using other sector companies, and increasing the research period. Other variables that are expected to affect shareholder value creation can be used in future research in order to gain more comprehension about factors affecting shareholder's value creation.

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