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The Effect of Corporate Governance on the Financial Performance of Pharmaceutical Sector Companies Listed on the Indonesia Stock Exchange

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Abstract

The purpose of this study was to determine the effect of corporate governance as measured by the Board of Commissionaire (BOC), Audit Committee (AC), Management (MANJ) and Shareholder (SH) on financial performance with the object of the pharmaceutical sector. This type of research is descriptive quantitative. The research population was 12 pharmaceutical sector companies, purposive sampling technique where the criteria were pharmaceutical sector companies that published complete financial reports from 2010-2021 so that the sample used was 108 data. The data used is secondary data with data collection through documentation. Data analysis using multiple linear regression. The results of this study are corporate governance in the dimensions of the Board of Commissionaire and Audit Committee has a significant positive effect on financial performance, corporate governance in the dimensions of Management and Shareholder has an insignificant positive effect on financial performance.

Keywords: *Corporate Governance; Financial Performance; Pharmacy*

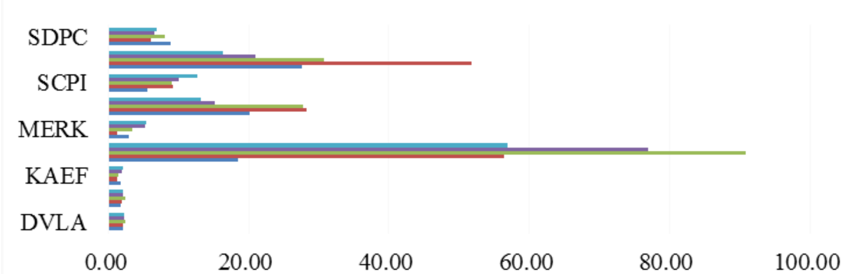
Introduction

The pharmaceutical industry has undergone significant changes over the past three decades, driven by advances in biological sciences and the emergence of biotechnology. The discovery of DNA's double helix structure and the development of genetic engineering techniques have greatly enhanced our understanding of drug mechanisms and the molecular basis of diseases. Consequently, this has opened up new opportunities for drug therapies and for companies operating in the pharmaceutical industry.

Pharmaceutical companies are part of the manufacturing industry sector and play a crucial role in supporting public health services, particularly in times of global health crises like the COVID-19 pandemic. The pharmaceutical industry also contributes significantly to the national economy. In Indonesia, there has been a notable growth in the pharmaceutical sector, evidenced by the increase in the number of pharmaceutical industries from 198 in 2015 to 230 in 2019, according to the Ministry of Industry of the Republic of Indonesia (2021).

The Performance Achievement Book of the Ministry of Industry for the period 2015-2019 highlights the pharmaceutical sector as one of the top five industrial sectors with significant investments. This demonstrates the strong performance and growth potential of the pharmaceutical industry (Ministry of Industry of the Republic of Indonesia, 2019).

To further analyze the performance of the pharmaceutical sector, data from the past five years (2017-2021) was collected. The graph below illustrates the performance of the pharmaceutical sector in Indonesia during this period:



	DVLA	INAF	KAEF	KLBF	MERK	PYFA	SCPI	TSPC	SDPC
2017	2.27	2.10	2.01	56.90	5.34	13.15	12.67	16.24	6.82
2018	2.22	2.01	1.82	76.98	5.16	15.11	9.98	21.00	6.47
2019	2.39	2.42	1.40	90.83	3.30	27.77	8.99	30.68	8.06
2020	2.01	1.97	1.23	56.40	1.22	28.19	9.10	51.76	6.11
2021	2.09	1.71	1.75	18.39	2.93	20.07	5.47	27.64	8.81

Figure 1. Performance of the Pharmaceutical Sector in Indonesia (2017-2021)

Based on Figure 1, it is evident that the financial performance of the pharmaceutical sector, as indicated by return on investment (ROI), is volatile. However, it is worth noting that the average ROI of the pharmaceutical sector falls below the industry standard of 30% for manufacturing companies, as stated by Kasmir (2016). Financial performance is a critical aspect of assessing a company's overall health, and the information obtained from financial reports influences decision-making processes. Companies are inclined to disclose information that can enhance their value, which includes both financial and non-financial information.

In 2022, a tragic incident occurred involving an Indonesian pharmaceutical company that produced a syrup medicine violating safety regulations, leading to the deaths of 324 children due to acute kidney failure caused by the syrup. The Food and Drug Supervisory Agency (BPPOM) responded by revoking the distribution licenses of all products from six pharmaceutical companies involved.

This case highlights the significant impact that pharmaceutical companies can have on public health and the importance of effective corporate governance. Corporate governance refers to the set of regulations and efforts aimed at improving systems and processes in organizational management, clarifying the relationships, authority, rights, and obligations of all stakeholders, including the General Meeting of Shareholders (GMS), the Board of Commissioners, and the Board of Directors (Hendro Lukman & CPMA, 2017). Implementing good corporate governance practices helps mitigate financial and non-financial risks (Siregar & Azzahra, 2022). The World Health Organization (WHO) emphasizes the role of corporate governance in reducing fraud and recommends the adoption of policies and procedures that promote effective, efficient, ethical, transparent, and accountable management systems.

Numerous studies highlight the essential role of corporate governance in the pharmaceutical sector. Ibrahim et al. (2010) argue that corporate governance significantly improves company performance, while Bhagat & Bolton (2008), Chauhan et al. (2016), and T. Yang & Zhao (2014) find a direct correlation between corporate governance and company performance.

In Indonesia, Mahrani & Soewarno (2018), Handriani & Robiyanto (2018), and El-Chaarani et al. (2022) have demonstrated the positive impact of corporate governance on financial performance. These studies suggest that managers who are shareholders and institutional investors influence financial performance positively. However, contrary findings by Guest (2009) in the UK, Saidat et al. (2019) in Jordan, and Kyere & Ausloos (2021) in the UK indicate a negative effect of corporate governance on financial performance. They argue that a larger board size hampers effective communication and decision-making, resulting in a weak supervisory role for the board of commissioners.

The objective of this study is to examine the impact of corporate governance, measured by the Board of Commissioners (BOC), Audit Committee (AC), Management (MANJ), and Shareholders (SH), on financial performance within the pharmaceutical sector.

Theoretical Foundations

Agency Theory

Agency theory arises from the inherent conflict of interest between principals and agents. According to Jensen & Meckling (1976), the agency relationship can be seen as a collection of contracts (nexus of contracts) between the owners of economic resources (principals) and the managers (agents) who are responsible for managing and controlling these resources. Shareholders seek increased profitability and dividends, while managers are motivated to satisfy their own economic and psychological needs. This misalignment of interests can lead to earnings management in financial reporting. To address the contractual problems between management and investors and mitigate opportunistic behavior, the implementation of good corporate governance (GCG) can serve as a monitoring mechanism.

Corporate Governance

The term "corporate governance" was introduced in the Cadbury Report by the Cadbury Committee in the UK in 1992. The Forum for Corporate Governance in Indonesia (FCGI, 2001) defines corporate governance as a system of rules that govern the relationships among shareholders, managers, creditors, government, employees, and other internal and external stakeholders. It emphasizes the rights of shareholders to access accurate and timely information and the obligation of companies to provide transparent disclosures regarding performance, ownership, and stakeholders. The Cadbury definition highlights the importance of formulating these relationships and establishing effective control mechanisms within the company.

Financial Performance

Hansen & Mowen (2007) classify company performance into two categories: financial performance and non-financial performance. Non-financial performance encompasses aspects related to quality, such as customer satisfaction or employee efficiency. On the other hand, financial performance, as described by Knight & Bertoneche (2000), focuses on the assessment of a company based on its financial statements and overall financial position. It requires a conceptual framework for reporting and managing financial matters.

Hypothesis Development

The Influence of the Board of Commissioners on Financial Performance

The Board of Commissioners holds a crucial role within the corporate governance framework. It is responsible for overseeing management policies, ensuring compliance with laws and regulations, and providing guidance to the Board of Directors. A larger number of commissioners can enhance the supervisory mechanism over company management, benefiting the company from a resource dependence perspective. The existence of an effective board of commissioners is expected to have a significant positive impact on financial performance (Chtourou, Marrachi, & Bedard, 2001; Kusmayadi & Hermansyah, 2018).

H1: The Board of Commissioners has a significant positive effect on financial performance.

The Effect of the Audit Committee on Financial Performance

The audit committee plays a critical role in overseeing financial reporting, external audits, and internal control systems. A larger audit committee size, with diverse experience and knowledge, is believed to improve company performance by enhancing the effectiveness of the committee's supervisory function. This results in better monitoring of management behavior and the reduction of opportunistic practices (DeAngelo, 1981; Watts & Zimmerman, 1981; Tornyeva & Wereko, 2012).

H2: The Audit Committee has a significant positive effect on financial performance.

Management's Influence on Financial Performance

The board of directors, as the company's governing body, collectively manages the company. The number of directors should be adjusted to the company's complexity while maintaining effectiveness in decision-making. Directors have a positive effect on financial performance, and their attributes play a central role in driving this performance. Structured governance functions, appropriate decision-making processes, and risk analysis are essential for improving financial performance (Samara & Berbegal-Mirabent, 2018; Roffia et al., 2021).

H3: Management has a significant positive effect on financial performance.

Shareholders' Influence on Financial Performance

Institutional ownership, represented by the percentage of shares owned by banks, insurance companies, pension funds, mutual funds, and other institutions, is considered an important corporate governance mechanism that improves company performance. Institutional investors have the ability and incentive to monitor and discipline company managers, reducing free-rider problems associated with dispersed ownership. Their presence and influence on board decisions positively affect firm performance (Aljifri & Moustafa, 2007; Ping & Wing, 2011; Rose, 2007; Shleifer & Vishny, 1997).

H4: Shareholders influence financial performance.

Research Methods

This type of quantitative descriptive research. The research population is 12 pharmaceutical sector companies on the Indonesia Stock Exchange, using a purposive sampling technique where the criteria are pharmaceutical sector companies that publish complete financial reports for 2010-2021 so that the sample used is 108 data. The data used is secondary data by collecting data through documentation. Data analysis using multiple linear regression.

Financial performance is measured by return on investment (ROI) where the most common performance measure for investment centers. Operating income refers to income before interest and taxes. Operating assets are all assets acquired to generate operating income, including cash, receivables, inventories, land, buildings and other equipment (Hansen & Mowen, 2007). The standard industry average Return on Investment (ROI) is 30% (Kasmir, 2016:203). The formula for finding ROI according to Hansen & Mowen, (2007);

$$Return\ on\ Invesment = \frac{Operating\ Income}{Average\ Operating\ Assets}$$

This study uses internal corporate governance mechanisms such as controlling the board of commissioners, board of directors, shareholders and audit committees that refer to research (Butt & Hasan, 2009; Klapper & Love, 2002; Wahidahwati, 2012). Scoring criteria and respective weights Presence of board of commissioner weight 45%, Audit Committee Weight 20%, Management Weight 20%, Shareholder Weight 15%

1) Board of Commissioner
a) Size of Commissioner

COM_SIZE = ∑ Commissioner Members

Table 1. Range Number of the Board of Commissioners

Range	Score
0-3	2
4-5	4
6-8	6
9-11	8
>11	10

Source: Wahidahwati (2010)

b) Independent Commissioner

COM_IND = (Members of the board of commissioners outside the company / Number of members of the board of commissioners of the company) x 100%

Table 2. Range of Independent Commissioners

Range	Score
0%-20%	2
21%-40%	4
41%-60%	6
61%-80%	8
81% and above	10

Source: Wahidahwati (2010)

c) Commissioner Ownership

%COM_OWN = (Board of commissioners share ownership / Total shares outstanding) x 100%

Table 3. Commissioner Ownership Range

Range	Score
0%-20%	2
21%-40%	4
41%-60%	6
61%-80%	8
81% and above	10

Source: Wahidahwati (2010)

d) Audits (Big Four or Non Big Four)

AUD (Big_Four), the existence of a large KAP, if there is, is given a score of 10, if there is none, it is given a score of 0

Table 4. Range Audits

Range	Score
Yes	10
No	0

Source: Wahidahwati (2010)

Board of Commissionaire = ∑ Size of Commissioner score + Commissioner Independent + Commissioner Ownership + Audit x 45%

2) Audit Committee

a) Size of Audit Committee

AUD_SIZE = ∑ Audit Committee Member

Table 5. Range Number of Audit Committee

Range	Score
0-3	2
4-6	4
6-8	6
9-11	8
>11	10

Source: Wahidahwati (2010)

b) Independent Audit Committee

AUD_SIZE = (Number of independent audit committee members / number of company audit committee members) x 100%

Table 6. Range of Independent Audit Committee

Range	Score
0%-20%	2
21%-40%	4
41%-60%	6
61%-80%	8
81% and above	10

Source: Wahidahwati (2010)

c)Finexpert

Finexpert, an expert in the field of consulting financial reports, if Yes is given a score of 10, If None is given a score of 0

Table 7. Finexpert Range

Range	Score
Yes	10
No	0

Source: Wahidahwati (2010)

Audit Committee = ∑ Size of Audit Committee score + Independent Audit Committee + Finexpert x 20%.

3) Management

a) Size of Directors

DIR_SIZE = ∑ Director board member

Table 8. Range Number of Board of Directors

Range	Score
0-3	2
4-6	4
6-8	6
9-11	8
>11	10

Source: Wahidahwati (2010)

b) Managerial Ownership

M_OWN = (Share ownership of board of directors & commissioners / total shares outstanding) x 100%

Table 9. Managerial Ownership Range

Range	Score
0%-20%	2
21%-40%	4
41%-60%	6
61%-80%	8
81% and above	10

Source: Wahidahwati (2010)

c) Family Relations

Family Relationship, family relationship, if there is given a score of 10, if there is not given a score of 0

Table 10. Range of Family Relations

Range	Score
Yes	10
No	0

Source: Wahidahwati (2010)

Management =∑ Size of Directors score + Managerial Ownership + Family Relations x 20%

4) Shareholders

INS_OWN = (Share ownership by other institutions / Total number of shares outstanding) x 100%

Table 11. Range of Shareholders

Range	Score
0%-20%	2
21%-40%	4
41%-60%	6
61%-80%	8
81% and above	10

Source: Wahidahwati (2010)

Shareholder = score of Shareholder x 15%

Analysis and Discussion

A. Data Analysis

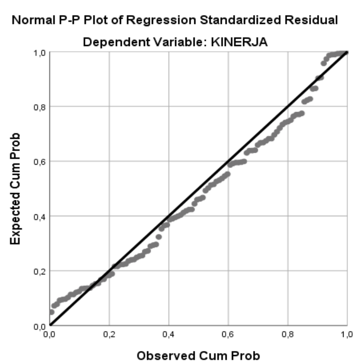


Figure 2. Normality Test
Source: SPSS output (data processed, 2023)

Figure 2 indicates that the data points in the distribution picture are spread or closely aligned around the diagonal line. The distribution appears to be normal or close to normal. The VIF (Variance Inflation Factor) values for BOC, SH, ManJ, and AC are 1.047, 1.124, 1.007, and 1.138, respectively.

These values are greater than 1, indicating no multicollinearity issues. Additionally, the tolerance values for BOC, SH, ManJ, and AC are 0.955, 0.890, 0.993, and 0.879, respectively, which are less than 10. These results suggest that the independent variables in the regression model do not suffer from multicollinearity problems, meeting one of the requirements for regression testing.

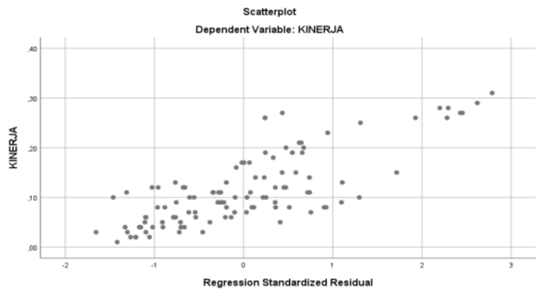


Figure 3. Heteroscedasticity Test
Source: SPSS output (data processed, 2023)

Figure 3 shows that the data points do not form a specific pattern, as they are scattered above and below zero. Therefore, it can be concluded that heteroscedasticity is not present in the data. The Durbin-Watson value is 1.145, which falls between -2 and +2. This indicates the absence of autocorrelation in the study.

The model fit test, as indicated by the F-test result of 0.000, is statistically significant ($p < 0.05$). Hence, the model is considered valid for the study.

The multiple linear regression equation is as follows:

Y = 23,260 + 2,025x1 + 6,924 x2 + 0,225x3 + 0,542X4

The regression coefficients show that a positive direction of X1 (BOC governance) indicates that better BOC governance leads to increased financial performance in pharmaceutical sector companies. Similarly, positive directions for X2 (AC governance), X3 (MANJ governance), and X4 (SH governance) imply that improved governance in these dimensions positively influences financial performance in the pharmaceutical sector.

The statistical test analysis reveals the following:

1. Corporate governance with the BOC dimension has a significance value of 0.002, indicating a significant positive effect on the financial performance of the pharmaceutical sector in Indonesia.
2. Corporate governance with the AC dimension has a significance value of 0.048, suggesting a significant positive effect on the financial performance of the pharmaceutical sector in Indonesia.
3. Corporate governance with the MANJ dimension has a significance value of 0.783, indicating an insignificant positive effect on the financial performance of the pharmaceutical sector in Indonesia.
4. Corporate governance with the SH dimension has a significance value of 0.062, signifying an insignificant positive effect on the financial performance of the pharmaceutical sector in Indonesia.

The analysis also reveals that the Adjusted R Square value is 0.117, indicating that 11.7% of the dependent variable (financial performance) is explained by the independent variables (corporate governance dimensions: BOC, AC, MANJ, and SH). The remaining 88.3% is attributed to other variables outside the scope of this study.

Discussion

The Influence of the Board of Commissioners on Financial Performance

The statistical test analysis reveals a significant positive effect of corporate governance in the BOC dimension on the financial performance of the pharmaceutical sector in Indonesia. This implies that better corporate governance practices concerning the Board of Commissioners, as measured by factors such as the size of the Board, presence of independent commissioners, ownership composition, and audit function, lead to increased financial performance.

The Board of Commissioners, representing the shareholders, plays a crucial role in overseeing company activities and formulating long-term strategies with the Board of Directors. They act as a counterbalance in the decision-making process and provide oversight to ensure good financial performance. The presence of independent commissioners is expected to enhance the supervisory function and minimize the possibility of deviant behavior by company management. This aligns with the research conducted by Chtourou, Marrachi, and Bedard (2001), which suggests that a larger number of commissioners improves the supervisory mechanism over company management.

Effect of the Audit Committee on Financial Performance

The corporate governance variable in the AC dimension has a significant positive effect on the financial performance of the pharmaceutical sector in Indonesia. This indicates that better corporate governance practices concerning the Audit Committee, as measured by factors such as the size of the committee, presence of independent members, and expertise in finance and auditing, lead to improved financial performance.

The audit committee plays a crucial role in reducing agency conflicts between shareholders and management. By overseeing external audits, financial reporting, and internal control systems, the audit committee helps prevent earnings management and other detrimental practices. Their responsibilities include ensuring fair presentation of financial statements, proper implementation of the internal control structure, adherence to audit standards, and follow-up on audit findings. Although the inclusion of an audit committee may impact the decline in ROI value, particularly when not all members possess accounting and finance expertise, a larger committee size has been found to positively influence company performance (Tornyeva and Wereko, 2012).

Management's Influence on Financial Performance

The corporate governance variable in the MANJ dimension has an insignificant positive effect on the financial performance of the pharmaceutical sector in Indonesia. This suggests that better corporate governance practices concerning management, such as the size of the Board of Directors, managerial ownership, and family relations, have the potential to improve financial performance, although the effect is not statistically significant.

Managerial ownership allows managers to have a voice in decision-making processes, preventing dominance and facilitating the formulation of strategies and policies related to company finances. Additionally, the presence of family members in management positions contributes to the development of an inclusive decision-making approach. Public accountability is essential for the company, considering the significant influence of external stakeholders. Research by Samara and Berbegal-Mirabent (2018) and Roffia et al. (2021) emphasizes the positive effect of directors on financial performance, highlighting the need for structured governance functions that suit each company's size.

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Shareholders' Influence on Financial Performance

The corporate governance variable in the SH dimension has an insignificant positive effect on the financial performance of the pharmaceutical sector in Indonesia. This suggests that better corporate governance practices related to shareholders have the potential to improve financial performance, but the effect is not statistically significant.

Shareholders, who hold a substantial portion of the company's invested wealth, are more exposed to corporate risk and have the means and incentives to monitor manager performance. Their involvement in day-to-day operations allows for better monitoring of managerial actions and decisions. Conflicts of interest between shareholders and managers give rise to agency costs. The effectiveness of institutional investors as a corporate governance tool is justified by their ability to discipline management (Rose, 2007).

Overall, corporate governance has a positive effect on financial performance. Studies by Ibrahim et al. (2010), Bhagat & Bolton (2008), Chauhan et al. (2016), T. Yang & Zhao (2014), El-Chaarani et al. (2022), Handriani & Robiyanto (2018), and Mahrani & Soewarno (2018) support the view that corporate governance is directly correlated with company performance and has a positive impact on financial performance.

Conclusion

In conclusion, this study demonstrates that corporate governance significantly impacts the financial performance of the pharmaceutical sector in Indonesia. The findings reveal that effective corporate governance practices, particularly in the dimensions of the Board of Commissioners (BOC) and the Audit Committee (AC), have a positive influence on financial performance. Improved corporate governance in the BOC dimension, as measured by factors such as the size of commissioners, independence of commissioners, ownership composition, and audit function, leads to increased financial performance. Similarly, better corporate governance in the AC dimension, as indicated by the size of the audit committee, presence of independent audit committee members, and expertise in finance and auditing, contributes to improved financial performance.

However, the study also highlights that corporate governance in the Management (MANJ) and Shareholders (SH) dimensions has an insignificant positive effect on financial performance. Although the impact is not statistically significant, it is still recommended for pharmaceutical sector companies to pay attention to management and shareholders, as their involvement can potentially influence financial performance.

It is important for pharmaceutical companies to prioritize effective corporate governance practices to foster a conducive environment for sustained financial performance. While the effects of management and shareholders may not be statistically significant, they should not be overlooked as they can still contribute to overall company performance and create a balance of interests between agents and principals.

It is worth noting that this study has limitations. The focus solely on the population of pharmaceutical sector companies restricts the generalizability of the findings. Additionally, the study does not extensively explore healthcare companies, which are relatively new and may have unique characteristics that were not fully examined. Future research should encompass a broader range of companies and incorporate additional variables to provide a more comprehensive analysis of corporate governance and its impact on financial performance in the pharmaceutical sector.

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