

THE EFFECT OF CORPORATE GOVERNANCE AND EARNINGS INFORMATION ON BOND RATINGS AND YIELDS

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Abstract: *The purpose of this research is to analyze effect of corporate governance and earnings information on bond ratings and yields. The proxies of corporate governance are institutional ownership, independent commissioner, audit committee, and managerial ownership. While the proxy of earning information is unexpected earning. Logistic regression is used to examine first hypothesis, and multiple regression is used to examine second hypothesis. Samples are all bonds that issued before January 1st, 2005 and mature after December 31st, 2007 which are rated by PEFINDO. The companies that issued bonds besides banking and financial institution should be listed in Indonesia Stock Exchange. The result of this research indicates that corporate governance and earnings information influence bond ratings and yields. The existence of independent commissioner has significant influence on bond ratings and yields. The existence of audit committee has significant influence on bond yields.*

Keywords: Institutional Ownership, Independent Commissioner, Audit Committee, Managerial Ownership, Unexpected Earnings, Bond Ratings and Bond Yields.

INTRODUCTION

Deciding whether investors want to make transaction in capital market or not, usually their decision are based on the information that they have, which have been influenced by the market. The information comes from public or their knowledge. Bond ratings and yields have significant role for them. Both of them become important information to get investment risk, recommendation investment and for comparison.

Bond ratings and yields become investor consideration. PEFINDO as an independent institute to rate Indonesian bonds helps investors to get information (Setyapurnama and Norpratiwi 2007). Faerber (2000) said investor who chose to invest in bonds than stock caused stock volatility was higher than bonds, so it less stock attractiveness; and bonds offered positive rate of return with fixed income, it showed bonds' safety.

Company also has same preferences to issued bonds than stock, the benefits by issued bonds are: it will not influence stockholder control because bondholders do not have voted right; it will save tax result, because issued bonds can reduce tax amount; and it can increase earning per share because not issued stocks.

In 2001, Komite Nasional Kebijakan Corporate Governance published good corporate governance orientation. According to Setyapurnama and Norpratiwi (2007), this orientation has purpose to company so that the business world have a basic guideline about the concept as well as the pattern of practice. Good corporate governance as common international system and especially for Indonesia. Corporate governance has positive relationship with bond ratings and has negative relationship with yields (Bhojraj and Sengupta 2003).

Research about effect of corporate governance on bond ratings and yields has done by last researchers. Research about bond ratings and yields has been done in US market, while still a few research about these that has done in Indonesia. Commonly their research shows that company which have good institutional ownership would have higher bond ratings and lower yields (Bhojraj and Sengupta 2003). Further, Karyani and Manurung (2006) explained about the relationship between bond ratings and yields, the higher risk of bond means, the higher yields (rate of return from obligation) offered, it is showed by lower bond ratings. On the other hand, the lower risk of the bond means, the lower yields (rate of return from obligation), it is showed by the higher bond ratings.

Statement of Financial Accounting Concepts (SFAC) No.1 (1978) states that financial reporting should give functional and potential information for investor decision. One of financial information is earning information, usually investors can use earnings information to make investment decision whether to invest in stock or bond. Research of Plummer and Tse (1999) tested bond ratings as a condition of company financial measurement. The result showed, when company financial was bad, earnings influenced to stock was decreased but increased to bond. On the other hand when company financial was good, earnings influenced to stock increased but decreased to bond.

The importance of bond rating and yields for investors before investing their fund, based on the good or bad of corporate governance (show from proxies institutional ownership, independent commissioner, managerial ownership, and audit committee) and earning information (measured by unexpected earnings) of the company. Based on those backgrounds, so researcher identifies these problems (1) do institutional ownership, commissioner independent, audit committee, managerial ownership and unexpected earnings influence bond ratings? (2) Do institutional ownership, commissioner independent, audit committee, managerial ownership and unexpected earnings influence bond yields?

THEORITICAL FRAMEWORK AND HYPOTHESIS DEVELOPMENT

Agency Theory

In economics, the principal-agent problem treats difficulties that arise under conditions of incomplete and asymmetric information when a principal hires an agent. Various mechanisms may be used to try to align the interests of the agent with those of the principal, such as piece rates/commissions, profit sharing, efficiency wages, the agent posting a bond, or fear of firing. The principal-agent problem is found in most employer/employee relationships, for example, when stockholders hire top executives of corporations.

Jensen and Meckling (1976) examined the relationship between principal and agent within the theory of the firm. Agency theory has identified the existence of two agency relationships. First, in the manager-shareholder relationship, the manager acts as an agent for the shareholders who are considered to be the owners. Shareholders are not in control of the company, since the managers make all pertinent decisions. Second, in the shareholder-debt holder relationship, the manager is assumed to act on behalf of the shareholders. Therefore, the debt holder is the principal and, as the manager acts on behalf of shareholders, the shareholders become the agent (Godfrey *et al.* 1992).

It caused agency risk. This represents the risk that management acting in its self-interest would take actions that deviate from firm value maximization, as well as the risk that the manger is incompetent. This agency problem has been well documented and cause managers to shirk and expropriate minority shareholders and creditors (Jensen and Meckling 1976), take actions that maximize short-term returns rather than long-term

returns (De Angelo and Rice 1983, Dechow and Sloan 1991, Murphy and Zimmerman 1993), and make potentially unprofitable investments in order to increase firm size and, possibly, total compensation (Murphy 1985, Jensen 1986).

Signaling Theory

Signaling theory explained why company should give information of financial reporting to external parties. This is a result of an information asymmetry between managers as internal parties and shareholders as external parties. That is, managers have more knowledge more about the firm's prospect than investors. One of many methods to reduce asymmetry information by give signal to external parties, provide reliable financial reporting. It can reduce indeterminacy of company prospect in future (Wolk et al. 2000).

Signaling theory suggests about how company should provide its financial reporting for users. This information about what management has done to realize the purpose of shareholder. This is used to promote the company or to show the company is better than others.

Bond Ratings

Bond ratings are the indicator of timely based to pay bond's principal and bond's interest. Beside that, bond ratings show the risk scale from trading bond. It means bond ratings show the bond safety scale in payment bond's principal and bond's interest periodically according to the agreement. The higher bond ratings, the lower of default risk.

Foster (1986) said that the function of bond are source of superior information to the company ability, municipal, or government to pay bond and interest, source of credit information with inter-company lower cost, municipal and government, source of additional financial and other management representation, to control appearing conflict between manager to other parties, to facilitate the public that limit speculative investment from institution, such as bank, insurance company and pension fund

Bond ratings are risk scale from all trading bonds. The scale shows the rate of safety bond can be prove by the ability of company to pay bond's principal and interest. Bond ratings can be categorized based on the risk into two major sectors (Setyapurnama and Norpratiwi 2007), they are (1) investment grade, which are the four highest rates (AAA, AA, A, BBB), (2) non-investment grade, which are the four lowest rates (BB, B, CCC, SD, D). This category is also known as high-yield, low-grade, or junk debts.

Bond Yields

Bond price and yields are two important variables in bond transaction for investor. Investor always asks for yields that they will receive for buy the bond in certainty price. Bond price and yields have connection each other and they have negative relationship. It means when yield get increase, bond price will get decrease and vice versa.

That's why yield become investor consideration to invest in bond. Yields are factor to measure annual rate of return that will receive by investor, or the benefit for investor in put their funds in bonds. There are two kinds of yield: current yield and yield to maturity (Fabozzi, 2000).

Current yield is coupon that is given by bond at the moment, connected with one year coupon from bond market price. Yield to maturity (YTM) is return that will receive by investor if they hold the bond until maturity date. Calculation of YTM is done by inputting the entire payment interest coupon until maturity date with assumption there is re-investment from received coupon with the same interest rate of the YTM (Kesumawati 2003).

Institutional Ownership

Institutional ownership means company shares that own by financial institution such as bank, insurance, pension fund, and investment banking (Siregar dan Utama 2006). Institutional ownership has ability to monitor management action better than individual ownership (Rachmawati dan Triatmoko, 2007). The research expect, the higher number of institutional ownership can show better company performance,so it can give positive influence on bond ratings and negative influence on yields.

Independent Commissioner

According Setiawan (2006), independent commissioner has significant role to monitor company management. The function is to motivate management become objective and pay attention to stockholder minority and other stakeholder. Management is responsible to increase efficiency and company performance. This important role should truly independent, to create good corporate governance. So, the research expect the higher number of commissioner independent can give positive influence on bond ratings and negative influence on yields.

Audit Committee

Based on BAPEPAM KEP 41/PM/2003, SK Dir. BEJ No. 315/BEJ/06-2000, Keputusan Menteri BUMN No. 117/Tahun 2000, and Undang-undang BUMN Nomor 19/2003, the conformation of audit committee is a must. Audit committee should be led by one of board commissioner. Audit committee has significant role in corporate governance. The duty of audit committee is to help board commissioner to fulfill their responsibility in controlling.

Audit committee should have no influence from management influence, external auditor, so audit committee has only responsibility to board commissioner. Audit committee has big responsibility in preparing audit, doing ratification to internal control system, and solving the differences in accounting role (George 2003).

Managerial Ownership

Iskander dan Chamlou (2000) stated that one important element of corporate governance is transparency. Transparency is an action to explain all things have been done by management to public. It's not easy to do it, if manager has own importance and private information to advocate himself. This condition can be happened if the manager in company has managerial ownership. The bigger percentage of managerial ownership, the smaller transparency will be disclosed, so the company has higher risk.

Earnings Information

Earnings information is indicated as the ability of earnings information to respond the market, especially to bondholders. In other words, earnings has power of response. Strong correlation market reaction to earnings information reflected from the high of earnings response coefficients, it shows the earnings reporting have good quality (Boediono 2005). In this research earnings information is measured by unexpected earnings.

Some researchers agree that earnings manipulation is usually done by manager. Composing earnings can be done by management who knows well company condition (Dechow, 1995). It can affect problem because management provide information about company performance will be evaluated based on its own report. The power of earnings information will get less in running business because manager is not the owner of company.

The characteristic of opportunistic management can cause low quality earnings information. Low-quality earnings information will make users of financial reporting such as investor and creditor make wrong

decisions. In this research, researcher will research the relationship between earnings information to creditor decision. Because earnings information not only important for stockholders but also for bondholders to make credit decision.

Audit committee should control company financial statement, external auditor, and internal control system. Based on those arguments, it is expected that good corporate governance can give confidence earnings information from the financial statement. Earning information which measured by unexpected earning is also expected that it can increase company value. As result has positive (negative) relationship to bond ratings (and yields).

Based on last researches Hypothesis for this research are:

H_{1a}: Institutional ownership has influence to bond ratings.

H_{1b}: Commissioner independent has influence bond ratings.

H_{1c}: Audit committee has influence to bond ratings.

H_{1d}: Managerial ownership has influence to bond ratings.

H_{1e}: Unexpected earnings has influence to bond ratings.

H_{2a}: Institutional ownership has influence to yields.

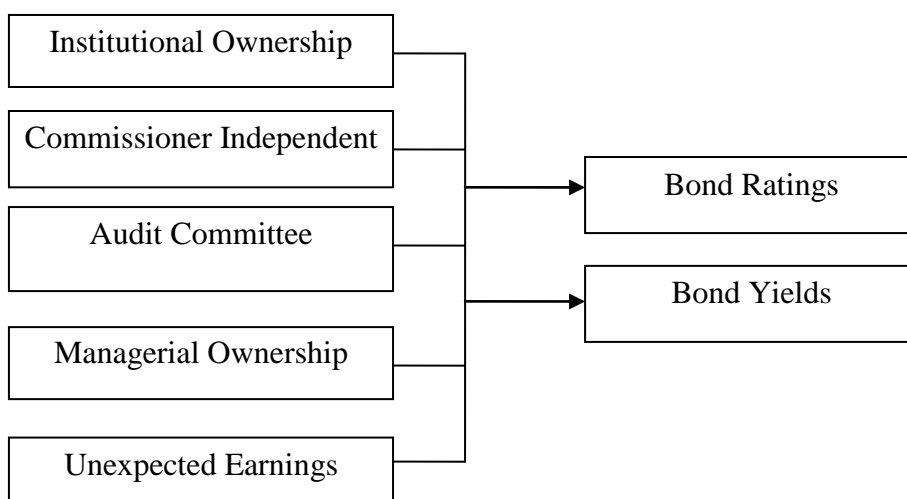
H_{2b}: Commissioner independent influence to yields.

H_{2c}: Audit committee influence to yields.

H_{2d}: Managerial ownership influence to yields.

H_{2e}: Unexpected earnings influence to yields.

Research model follow:



Picture 1 Research Model

RESEARCH METODOLOGY

Sampling and Collecting Data

Population from this research is all bonds which are rated by Pefindo and issued by companies besides banking and financial institution which are listed in Indonesian Stock Exchange (IDX) between 2005 until 2007. Unit analysis for this research is company level. Researcher uses purposive sampling method in determining sampling, which is sample selected based on certain criteria and consideration. The criteria and consideration are set as follow (1) bonds that issued by company are rated by PEFINDO within 2005 to 2007, (2) The company is not included bank and financial institution are listed in Indonesia Stock Exchange from 2004-2007, (3) the bonds have been issued before January 1, 2005 and mature after December 31, 2007, (4) bonds are not categorized as syariah bonds, (5) bonds are not bought back and delisting.

This study examines all bonds which are rated PEFINDO which are issued by companies besides banking and financial institution and listed in Indonesia Stock Exchange (IDX) from the period year 2005 until 2007. Data consist of 25 companies which are 38 bonds used as sample in this research. The research data are secondary data collected from www.pefindo.co.id, Indonesia Stock Exchange, and Indonesia Capital Market Directory.

Variable Definition and Measurement

Bond ratings can be categorized according to their ratings (Setyapurnama and Norpratiwi 2007). These are (1) investment grade for company has low risk default. The ratings are AAA-BBB, (2) speculative grade for companies that have high risk default. The ratings are BB-D. We give 0 for company in speculative grade and 1 for company in investment grade.

Bond price and **yields** are two important dependent variables for investor's decision. Investor always asks yield for bonds that they will buy in a certain price. In this research we use Yield to Maturity (YTM) to calculate return that will investor receive if they hold the bond until maturity date. This based on Bhojraj and Sengupta (2003) research. We calculate YTM use YTM approximation to make it simplify. The formula for YTM approximation is:

$$YTM \text{ approximation} = \frac{C + \frac{R - P}{n}}{\frac{R + P}{2}} \times 100\%$$

Explanation:

C: Coupon

n: Rest period

R: Redemption value

P: Purchasing price

Institutional ownership is measured the percentage of institutional ownership in company. According to Bhojraj and Sengupta (2003) this variable is measured by proportion of shares owned by institutional in the end of year.

$$\text{Institutional ownership} = \frac{\text{Number of shares owned by institutional}}{\text{Total outstanding shares}}$$

Independent commissioner is measured the percentage of number of independent commissioner to total of board commissioner in company that issued bond (Bhojraj and Sengupta 2003).

$$\text{Independent Commissioner} = \frac{\text{Number of Independent Commissioner}}{\text{Total of board commissioner}}$$

Audit committee is dummy variable. It is measured how many people in audit committee. The effective number of committee audit is three. Company that has three or more people in audit committee is given score one, while for company that has less than three person is given score zero.

Managerial ownership is dummy variable. It measured company has or doesn't have managerial ownership. The scale measurement is nominal scale. Company that has managerial ownership is given score one, while for company doesn't have managerial ownership is given score zero.

Earnings information is measured unexpected earnings in this research. Unexpected earnings is the difference between real earnings with expected earnings (Sari and Zuhrohtun 2006). Unexpected earnings gets from earning current estimate with previous earnings. The formula is:

$$UE_{it} = \frac{E_{it} - E_{it-1}}{|E_{it-1}|}$$

Explanation:

UEit: Company's unexpected earnings *i* in *t* period

Eit: Company's accounting earnings *i* in *t* period

Eit-1: Company's accounting earnings *i* in *t*-1 period

RESULT OF RESEARCH

To decided whether alternative hypothesis being accepted or rejected can be valuated by value of Sig. in Variables in the Equation table below:

Table 1 The Effect of Corporate Governance and Earnings Information on Bond Ratings

Variable	B	Wald	Sig.
Constant	12.378	13.417	.000
Institutional ownership	-9.813	9.301	.002
Independent commissioner	-7.093	4.728	.030
Audit committee	.628	.139	.710
Managerial ownership	-2.250	2.553	.110
Earnings information	.392	2.731	.098

From the table above, the Sig. value of institutional ownership variable is 0.002 below 0.05 and H_{1a} being accepted. It means that institutional ownership has significant influence to bond ratings. This result is consistent with research done by Bhojraj and Sengupta (2003), Ajinkya *et al.* (1999), Healey *et al.* (1999), but inconsistent with result from Setyapurnama and Norpratiwi (2007).

For independent commissioner, Sig. value shows 0.030 below 0.05 means H_{1b} being accepted. It means that independent commissioner has significant influence to bond ratings. This result is also proves Bhojraj and Sengupta (2003), Ajinkya *et al.* (1999), Setyapurnama and Norpratiwi (2007).

Sig. value of audit committee shows 0.710 above 0.05 and the result is H_{1c} being rejected. It means that audit committee has no significant influence to bond ratings. This result is consistent with Setyapurnama and Norpratiwi (2007) who proved that audit committee has no significant influence to bond ratings.

For managerial ownership, Sig. value shows 0.110 above 0.05 and the result is H_{1d} being rejected. It means that managerial ownership has no

significant influence to bond ratings. This result is consistent with research done by Setyapurnama and Norpratiwi (2007) that proved managerial ownership has no significant influence to bond ratings.

Sig. value of unexpected earnings shows 0.098 above 0.05 and the result is H_{1d} being rejected. It means that unexpected earning has no significant influence to bond ratings. This result is inconsistent with research done Sari and Zuhrohtun (2006), Plummer and Tse (1999).

Table 2 The Effect of Corporate Governance and Earnings Information on Bond Yields

Variable	t	Sig.	Decision
Institutional ownership	-1.015	0.313	Reject H_{2a}
Independent commissioner	-5.080	0.000	Accept H_{2b}
Audit committee	4.622	0.000	Accept H_{2c}
Managerial ownership	-0.183	0.855	Reject H_{2d}
Earnings information	-0.442	0.659	Reject H_{2e}

R 0.484, Adjusted R Square 0.193, F 5.628 Sig. 0.000

From the table above, Sig. value of institutional ownership as independent variable is 0.313 above 0.05 and H_{2a} being rejected. It means that institutional ownership has no significant influence to bond yields. This result is consistent with research done by Setyapurnama and Norpratiwi (2007), Karpoff *et al.* (1996), but inconsistent with result from Bhojraj and Sengupta (2003).

For independent commissioner, Sig. value shows 0.000 below 0.05 and the result is H_{2b} being accepted. It means that independent commissioner has significant influence to bond yields. This result also proves by Setyapurnama and Norpratiwi (2007), Bhojraj and Sengupta (2003), Karpoff *et al.* (1996).

Sig. value of audit committee 0.000 below 0.05 and the result is H_{2c} being accepted. It means that audit committee has significant influence to bond yields. This result is consistent with research done by Setyapurnama and Norpratiwi (2007).

For managerial ownership, Sig. value shows 0.855 above 0.05 and the result is H_{2d} being rejected. It means that managerial ownership has no significant influence to bond yields. This result also proves by Setyapurnama and Norpratiwi (2007).

Sig. value of unexpected earning 0.659 above 0.05 and the result is H_{2c} being rejected. It means that unexpected earning has no significant influence to bond yields. This result is inconsistent with research done by Sari and Zuhrohtun (2006), Plummer and Tse (1999).

CONCLUSION, LIMITATION AND RECOMMENDATION

Based on hypothesis test result, the conclusion can be drawn as follows (1) Institutional ownership has significant influence on bond ratings, (2) independent commissioner has significant influence on bond ratings, (3) audit committee has not significant influence to bond ratings, (4) managerial ownership has not significant influence to bond ratings, (5) unexpected earnings has not significant influence to bond ratings, (6) institutional ownership has not significant influence to bond yields, (7) independent commissioner has significant influence to bond yields, (8) audit committee has significant influence to bond yields, (9) managerial ownership has not significant influence to bond yields, (10) unexpected earnings has not significant influence to bond yields.

This research is subjected to several limitations, as follow (1) data only consist of 25 companies which are 38 bonds issued, (2) the time period of observation that only taken from 2005 until 2007. The recommendations which may be used for future research are as follow (1) to use more data so the research result can generalization better, (2) to extend the time period of observation to get more accurate results.

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