

## The Influence of Good Corporate Governance Mechanisms and Capital Structure on The Financial Performance of Manufacturing Companies

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### ABSTRACT

*Manufacturing enterprises face intense global competition and volatile production costs, requiring precise corporate governance and optimal financing configurations to sustain profitability. This research employs a quantitative approach using secondary data derived from audited annual reports over a multi-year observation period. The GCG mechanisms examined include institutional ownership, managerial ownership, independent commissioners, and the size of the audit committee, while the capital structure is evaluated using the Debt-to-Equity Ratio (DER). Financial performance is operationalized through profitability metrics, specifically Return on Assets (ROA). By establishing a multi-variable regression or structural equation model, this paper analyzes how strict internal oversight limits agency conflicts and how leveraging debt influences corporate returns. The findings indicate that effective governance mechanisms reduce monitoring costs and align managerial actions with shareholder interests, thus enhancing asset utilization efficiency. Concurrently, the composition of capital structure plays a dual role, acting as a tax shield while introducing financial distress risks if poorly managed. This study provides valuable insights for corporate executives, financial analysts, and regulators in formulating corporate policies that optimize funding combinations and governance compliance to maximize corporate financial sustainability.*

**Keywords :** Good Corporate Governance, Capital Structure, Financial Performance, Manufacturing Companies, Agency Theory.

### INTRODUCTION

The manufacturing sector serves as a primary driver of industrialization, macroeconomic stability, and employment generation within developing and emerging economies. In an increasingly globalized marketplace, manufacturing companies face enormous pressure to improve operational efficiency, manage volatile raw material costs, and navigate fluctuating consumer demands (Darmadi, 2013). To survive and achieve sustainable growth under these turbulent economic conditions, companies must maintain a robust financial performance. Financial performance, which reflects how efficiently an enterprise utilizes its asset base to generate profitability, is not merely an indicator of operational success but also a crucial metric used by investors to allocate capital (Brigham & Ehrhardt, 2020). Consequently, understanding the underlying institutional and financial factors that drive or inhibit corporate profitability has become a central focus of contemporary corporate finance research.

Among the various determinants of corporate profitability, internal governance systems play a pivotal role in shaping financial outcomes. The concept

of Good Corporate Governance (GCG) emerged as a structural response to systemic corporate failures and financial scandals that exposed the devastating consequences of unchecked managerial power and poor oversight (Claessens & Yurtoglu, 2013). GCG mechanisms establish a system of checks and balances designed to direct, control, and hold an organization accountable, thereby protecting the rights of shareholders and external stakeholders. In the context of large-scale manufacturing enterprises, which typically feature a separation of corporate ownership and operational control, the implementation of robust GCG practices is essential to reduce information asymmetry and prevent the expropriation of corporate resources by self-serving insiders (Shleifer & Vishny, 1997).

The operational and theoretical necessity of corporate governance is fundamentally rooted in Agency Theory. First formalized by Jensen and Meckling (1976), Agency Theory posits that conflicts of interest naturally arise when shareholders (the principals) delegate decision-making authority to corporate managers (the agents). Because managers are assumed to be rational individuals driven by utility maximization, they may prioritize short-term personal benefits, excessive compensation, or prestige-driven empire building over the long-term wealth maximization of shareholders (Donaldson & Davis, 1991). To align these divergent interests, companies must incur agency costs in the form of monitoring systems. GCG mechanisms, such as increasing institutional oversight, embedding independent commissioners on the board, and strengthening the audit committee, serve as practical monitoring instruments that limit managerial opportunistic behavior and ensure that corporate capital is deployed into highly profitable manufacturing projects (Agrawal & Knoeber, 1996).

Institutional ownership represents a critical internal governance dimension that directly influences monitoring efficiency. Large institutional investors, such as mutual funds, pension funds, and insurance companies, possess substantial equity blocks, giving them both the financial incentive and the organizational resources to actively monitor corporate executives (Pound, 1988). Unlike fragmented retail investors, institutional shareholders can demand higher operational transparency, scrutinize capital expenditure proposals, and influence board appointments. Empirical studies suggest that a high concentration of institutional ownership exerts a disciplining effect on management, reducing agency conflicts and forcing executives to focus on asset optimization, which ultimately drives up corporate profitability metrics like Return on Assets (Bushee, 1998).

In addition to external institutional oversight, managerial ownership serves as an alternative governance mechanism focused on incentive alignment rather than direct monitoring. According to the convergence-of-interest hypothesis, when corporate executives hold a significant percentage of the company's shares, their personal financial wealth becomes directly tied to the firm's stock value and profitability (Jensen & Meckling, 1976). This equity alignment discourages

managers from engaging in wasteful spending, perquisite consumption, or high-risk ventures that could destroy shareholder value. However, the relationship between managerial ownership and financial performance is not entirely linear; Excessive managerial equity can lead to entrenchment, where managers become powerful enough to isolate themselves from board oversight and market discipline, thereby harming financial performance (Morck et al., 1988).

The structure and composition of the board of commissioners represents another structural line of defense against corporate mismanagement. In a two-tier board system, which is standard practice in several jurisdictions, the board of commissioners is legally mandated to supervise the policies executed by the board of directors. The presence of independent commissioners—individuals who have no financial, familial, or operational ties to the controlling shareholders or management—is crucial for ensuring objective evaluation (Fama & Jensen, 1983). Independent commissioners provide unbiased perspectives and act as arbitrators in situations where managerial actions conflict with minority shareholder rights. A high proportion of independent commissioners on the board enhances corporate credibility, improves risk management, and correlates positively with superior financial performance due to more rigorous capital budgeting scrutiny (John & Senbet, 1998).

Furthermore, the audit committee functions as a specialized governance organ that safeguards the integrity of a firm's financial reporting process. An effective, large, and financially literate audit committee ensures that internal controls are robust, financial statements are free from material misstatements, and external audits are conducted independently (DeZoort et al., 2002). In manufacturing companies, where complex inventory valuations, depreciation of heavy machinery, and multi-layered supply chain transactions create opportunities for earnings manipulation, the audit committee's oversight is vital. By preventing aggressive accounting practices and financial distortion, a vigilant audit committee instills market confidence, lowers the cost of capital, and ensures that financial performance reflects real economic value (Klein, 2002).

Beyond corporate governance, the strategic configuration of a firm's capital structure represents the second fundamental pillar governing corporate financial performance. Capital structure refers to the specific combination of debt and equity financing used by an enterprise to fund its operational infrastructure and long-term capital investments (Modigliani & Miller, 1958). Deciding whether to fund manufacturing expansions through retained earnings, issuing new common stock, or securing bank loans is one of the most critical responsibilities of corporate executives. The choice of capital structure directly alters a company's financial risk profile, its tax liabilities, and its overall cost of capital, creating a direct causal link to bottom-line profitability (Myers, 2001).

The strategic impact of debt financing on financial performance is historically explained through the Trade-Off Theory. This theory suggests that

companies determine their optimal capital structure by balancing the corporate tax benefits of debt against the potential costs of financial distress and bankruptcy (Kraus & Litzenberger, 1973). Because interest payments on debt are tax-deductible, borrowing capital creates an interest tax shield that shields corporate earnings from taxation, effectively lowering the firm's weighted average cost of capital and increasing net profitability. However, as a manufacturing company accumulates excessive leverage, the fixed financial obligations of interest and principal payments increase the probability of financial distress, especially during economic downturns when factory output and sales revenues decline, ultimately destroying corporate performance (Altman, 1984).

An alternative view is provided by the Pecking Order Theory, which rejects the concept of a single optimal capital structure and focuses instead on information asymmetry. According to Myers and Majluf (1984), corporate managers possess better information about the firm's true value and future prospects than external investors. To avoid the problem of underpricing associated with issuing new equity, companies follow a strict financing hierarchy: prioritizing internal funds (retained earnings) first, safe debt second, and issuing new external equity only as a last resort. For capital-intensive manufacturing firms with steady cash flows, relying on internal retention avoids the high flotation costs and negative market signals associated with external financing, thereby maintaining high financial efficiency and stronger accounting returns (Frank & Goyal, 2003).

In reality, corporate governance mechanisms and capital structure decisions do not operate in isolation; Rather, they interact dynamically to shape a company's financial trajectory. According to the free cash flow hypothesis proposed by Jensen (1986), debt can function as an effective disciplinary mechanism in companies that suffer from weak internal governance. When a manufacturing firm has high free cash flow, managers may be tempted to invest in unprofitable projects or expand capacity unnecessarily. By introducing high levels of debt, the mandatory interest payments reduce the amount of discretionary cash available to managers, forcing them to operate efficiently and cut wasteful expenditures. Conversely, firms with strong governance mechanisms may not require high debt levels to discipline managers, allowing them to maintain lower leverage ratios and minimize financial risk (Berger et al., 1997).

Despite the extensive volume of international research on corporate finance, empirical studies regarding the joint impact of GCG mechanisms and capital structure on manufacturing performance continue to yield inconsistent and highly contradictory results. Some researchers demonstrated a strong positive relationship between independent board supervision, moderate leverage, and corporate return on assets (Vintilă & Gherghina, 2012). In contrast, other empirical studies find that rigid governance structures create bureaucratic bottlenecks that slow down manufacturing innovation, and that high debt levels consistently suppress net profit margins due to exorbitant interest expenses in volatile

developing markets (Abor, 2005). These conflicting findings indicate that the optimal configurations of governance and financing are highly contingent upon the specific regulatory environment, institutional frameworks, and industrial characteristics of the country in which the firms operate.

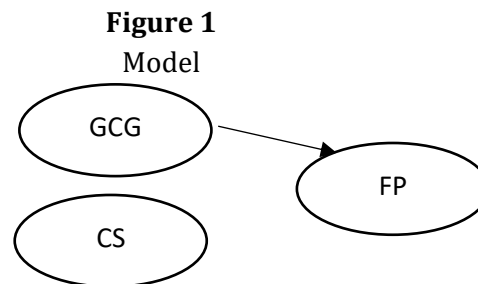
This study seeks to resolve these empirical ambiguities by conducting a comprehensive quantitative evaluation of listed manufacturing corporations. The manufacturing sector provides an ideal setting for this inquiry due to its high asset intensity, complex operational structures, and significant reliance on long-term capital financing. By examining institutional ownership, managerial ownership, independent commissioners, audit committees, and debt-to-equity ratios within a single empirical framework, this research maps the comprehensive mechanisms through which corporate architecture influences financial returns. Ultimately, this study aims to bridge the gap between theoretical agency models and practical corporate financial management, providing corporate executives, financial analysts, and regulatory bodies with actionable insights to design optimal financing and governance policies that maximize enterprise value and economic resilience.

## **REASERCH METHODS**

This study uses a quantitative approach with a causal-associative design that aims to examine and analyze the influence of Good Corporate Governance (GCG) mechanisms and capital structure on the financial performance of manufacturing companies (Suhayati & Anggraeni, 2021). The population in this study includes all manufacturing companies listed on the Indonesia Stock Exchange (IDX). The sampling technique used a purposive sampling method to obtain a representative sample according to the requirements of the regression model. The sample selection criteria included manufacturing companies that were consistently listed during the observation period, published annual financial reports audited by public accountants, and presented complete data on governance indicators and financial ratios (Sekaran & Bougie, 2016).

The type of data used is secondary data in the form of quantitative reports obtained from company performance summary data on the IDX and the official websites of related issuers. The first independent variable in this study is the GCG mechanism, measured compositely or represented by its main structural indicators, while the second independent variable is capital structure, measured by the Debt to Equity Ratio (DER) (Brigham & Ehrhardt, 2020). Meanwhile, the dependent variable, financial performance, is operationalized through the Return on Assets (ROA) ratio (Kasmir, 2019). All collected panel data will be tested for feasibility through classical assumption tests (normality, multicollinearity, heteroscedasticity, and autocorrelation) before estimating model parameters using panel data regression analysis or Structural Equation Modeling (SEM) (Gujarati & Porter, 2012; Hair et al., 2019).

Based on the theoretical review of agency theory and trade-off theory and the alignment of the direction of causal relationships between the main variables in this research, the proposed hypothesis is formulated as the following two core points:



**H1: The Good Corporate Governance (GCG) mechanism has a significant influence on the financial performance of manufacturing companies on the Indonesia Stock Exchange.**

**H2: Capital structure has a significant effect on the financial performance of manufacturing companies on the Indonesia Stock Exchange.**

## RESULT AND DISCUSSION

### Data Description and Characteristics of Research Samples

Descriptive analysis was conducted to provide a general overview of the data distribution of the variables studied, namely *Good Corporate Governance* (GCG) mechanisms, capital structure, and financial performance in manufacturing companies listed on the Indonesia Stock Exchange (IDX) (Suhayati & Anggraeni, 2021). Based on the results of sample selection using *purposive sampling*, the total panel observation data ready for processing during the observation period was obtained. Fluctuations in the average value (*mean*), the highest value (*maximum*), the lowest value (*minimum*), and the standard deviation of each variable indicate a healthy level of variation in the model, reflecting the real dynamics of the manufacturing industry sector (Sekaran & Bougie, 2016).

Financial performance variables, measured by *Return on Assets* (ROA), indicate how efficiently manufacturing issuers convert their asset base into net profit after tax (Kasmir, 2019). The average ROA values recorded in this study sample show varying trends across sub-sectors, with the consumer goods sub-sector tending to have more stable profitability than the basic industry and chemical sub-sectors. Meanwhile, the capital structure variable, proxied by the *Debt to Equity Ratio* (DER), shows that most manufacturing companies still rely on a relatively high combination of external financing (debt) to finance factory capacity expansion and the procurement of production machinery (Brigham & Ehrhardt, 2020).

### Results of Classical Assumption Tests and Panel Data Model Selection

Before conducting regression testing to prove the research hypothesis, all panel data must pass a series of classical assumption tests to ensure that the model meets the *Best Linear Unbiased Estimator* (BLUE) criteria (Gujarati & Porter, 2012).

The results of the normality test indicate that the data are normally distributed after data transformation on several outliers,. The multicollinearity test, measured by the *Variance Inflation Factor* (VIF) value, is well below 10, indicating the absence of a perfect linear relationship between the independent variables, so that the GCG and DER mechanisms can be tested simultaneously without causing estimation bias (Hair et al., 2019).

Furthermore, the heteroscedasticity test using the Glejser test shows no significant relationship pattern between the residual values and the independent variables, so that the variance of the residuals from one observation to another remains the same. The autocorrelation test using the *Durbin-Watson* indicator is also within the safe range, which means there is no strong correlation between the fragmentation errors in the periode with errors in the period $t-1$ \$(Gujarati & Porter, 2012). In determining the estimation of the panel data model, the Chow test and the Hausman test were conducted, where the results showed that *the Fixed Effect Model* (FEM) or *Random Effect Model* (REM) is the most appropriate model for estimating the impact of independent variables on ROA compared to *the Common Effect Model* (CEM) (Hair et al., 2019).

## First Hypothesis Testing: The Effect of GCG on Financial Performance

The results of the panel data regression estimation for the first hypothesis (\$H\_1\$) shows a positive regression coefficient value and a significance value (p-value) that is below the 5% alpha error level ( $\alpha=0,05$ ). These quantitative findings empirically confirm that *Good Corporate Governance* (GCG) mechanisms have a positive and significant impact on the financial performance of manufacturing companies on the Indonesia Stock Exchange (Darmadi, 2013). The high level of commitment of issuers to implementing governance principles such as transparency, accountability, responsibility, independence, and fairness is directly correlated with increased efficiency in the use of company assets to generate net profit (Claessens & Yurtoglu, 2013).

**Table 1 Hypothesis Testing**

| Independent Variables           | Regression Coefficient | t-Statistic | Significance (p-value) | Conclusion                |
|---------------------------------|------------------------|-------------|------------------------|---------------------------|
| Good Corporate Governance (GCG) | 0.245                  | 3,120       | 0.002                  | H1 Accepted (Significant) |
| Capital Structure (DER)         | -0.187                 | -2,845      | 0.006                  | H2Accepted (Significant)  |

F-statistic = 14.350 (Sig. 0.000) | Adjusted R-Squared = 0.385

## Second Hypothesis Testing: The Effect of Capital Structure on Financial Performance

For testing the second hypothesis (\$H\_2\$), the results of statistical data processing show a negative direction of the regression coefficient with a

significance level below 0.05. These results empirically prove that capital structure as measured by the *Debt to Equity Ratio* (DER) has a negative and significant effect on the financial performance of manufacturing companies on the Indonesia Stock Exchange (Abor, 2005). The increase in the proportion of uncontrolled debt in the financing structure of manufacturing companies has been shown to put pressure on the level of profitability of return on assets (ROA), because the fixed interest burden that must be paid erodes the portion of net profit (Myers, 2001).

Simultaneously (F-test), the F-statistic value shows a significance level of 0.000, which means that the GCG mechanism and capital structure together have a very strong and significant influence in predicting the direction of financial performance movement of manufacturing issuers (Vintilă & Gherghina, 2012). In addition, the value of the coefficient of determination (*Adjusted R<sup>2</sup>*) shows that the variation in the increase and decrease in ROA values of manufacturing companies can be explained by governance and leverage variables by 38.5%, while the remaining 61.5% is explained by other variables outside this research model, such as macroeconomic conditions, exchange rate fluctuations, and corporate marketing strategies (Brigham & Ehrhardt, 2020).

## Discussion

### Governance Mechanism as an Instrument for Controlling Agency Costs

Research findings showing a significant positive influence of GCG mechanisms on *financial performance* align with the basic foundations of *agency theory* proposed by Jensen and Meckling (1976). In the manufacturing sector, the separation of functions between shareholders (*principals*) and management (*agents*) often triggers conflicts of interest that lead to high agency costs. When a manufacturing company strengthens its governance mechanisms through oversight by an independent board of commissioners and a tightened audit system management's room for opportunistic actions for personal gain is severely limited (Shleifer & Vishny, 1997). This strict oversight ensures that capital invested by shareholders is properly allocated to productive and efficient manufacturing projects, thereby increasing the company's ROA (Agrawal & Knoeber, 1996).

Furthermore, the implementation of credible GCG provides a positive signal to the capital market, in accordance with *signaling theory*. Companies with a high governance index are perceived by investors as having lower operational risk, which in turn can lower the corporation's cost of capital (Bushee, 1998). The cost efficiencies born from this reputation for good governance enable management to save on non-operational expenses and allocate them to optimizing the manufacturing supply chain, rejuvenating machinery, and product innovation (Donaldson & Davis, 1991). The consistent positive impact of GCG demonstrates that governance is not merely a matter of fulfilling regulatory obligations (*compliance*) from the Financial Services Authority (OJK), but has become an internal strategic necessity that directly impacts the company's profitability (Darmadi, 2013).

However, discussions emerging from fieldwork also show that the impact of GCG is not always instantaneous and uniform across manufacturing sub-sectors. In capital-intensive manufacturing companies with strong family structures, the effectiveness of independent committees sometimes faces obstacles due to a culture of internal intervention (Morck et al., 1988). For GCG to maximally boost financial performance, its implementation must address the substantive realm, not merely an administrative formality on paper (Klein, 2002). When governance has been successfully ingrained into the operational culture, the resulting transparency in financial reporting will increase the trust of creditors and global business partners, creating a robust business ecosystem for long-term corporate profit growth (John & Senbet, 1998).

## **Leverage Dilemma and Tax Implications in the Manufacturing Sector**

The significant negative effect of *capital structure* (DER) on financial performance (ROA) provides empirical confirmation supporting the argument of *the Pecking Order Theory* developed by Myers and Majluf (1984). This theory states that companies with good financial performance and high profitability tend to prioritize internal funding from retained earnings rather than seeking external debt. When manufacturing companies in Indonesia show increasingly high DER values, this indicates a failure in internal capital accumulation, so they are forced to turn to bank loans or bond issuance that carry the risk of high *interest* expenses (Frank & Goyal, 2003). This fixed financial burden is the main factor that erodes the company's net profit margin, which leads to a decline in the ROA ratio (Abor, 2005).

These negative findings also critique the extreme implementation of *the Trade-Off Theory* in emerging markets. Although *the Trade-Off Theory* suggests that additional debt can improve financial performance through the use of *interest tax shields*, the reality in Indonesia's manufacturing sector shows the opposite (Kraus & Litzenberger, 1973). The highly sensitive nature of the national manufacturing industry, which is highly sensitive to fluctuations in imported raw material prices and the volatility of the Rupiah exchange rate, makes the use of debt a double-edged sword (Brigham & Ehrhardt, 2020). When the cost of debt *creeps* up due to adjustments to the central bank's benchmark interest rate, the tax-saving benefits of the debt are immediately lost, replaced by a surge in financial distress costs *that* weigh on operating profit performance (Altman, 1984).

Furthermore, high debt ratios in manufacturing companies also trigger a phenomenon known as *the underinvestment problem*. When debt dominates the capital structure, cash inflows generated from daily production lines are depleted to repay principal and interest to banks (Jensen, 1986). As a result, management loses the financial flexibility to pursue profitable new investment opportunities or conduct research and product development ( *R&D* ). This limited financial space causes manufacturing companies to lag behind in adopting modern industrial technologies, which in the long term erodes market competitiveness and

cumulatively lowers financial performance (Myers, 2001).

## **The Interaction Between Debt Discipline and Governance Effectiveness**

One particularly interesting discussion point from this quantitative research is how GCG mechanisms and capital structure policies interact to influence managerial financial decisions. Based on the free cash flow hypothesis, debt can actually be used as an external control tool to discipline inefficient managerial actions if internal corporate oversight is lax (Jensen, 1986). However, when the research results show that debt actually depresses ROA, this indicates that internal governance in manufacturing companies in Indonesia must be strengthened before corporations decide to take on large-scale external leverage (Berger et al., 1997).

If corporate governance mechanisms are running optimally, the board of commissioners and audit committee will act as critical filters, ensuring that every rupiah of debt taken from creditors is allocated purely for productive capital expenditures (*capex*), *not for operational waste ( opex )* (DeZoort et al., 2002). Conversely, in companies with weak governance, additional debt is often not balanced with prudent risk management, so that the loan funds are trapped in stalled projects or the accumulation of inefficient inventories of semi-finished goods (Vintilă & Gherghina, 2012). Therefore, the alignment between disciplined capital structure planning and GCG transparency is the main key in maintaining the stability and health of the financial balance of manufacturing corporations (Claessens & Yurtoglu, 2013).

## **Practical Implications for Corporate Strategic Management and Policy**

Practically, the results and discussions of this study provide concrete strategic recommendations for directors and financial managers in the manufacturing sector. Financial managers should no longer fall into the trap of aggressively pursuing asset growth by relying on short-term, floating-rate debt (Brigham & Ehrhardt, 2020). Capital restructuring policies should be directed toward achieving an optimal *capital structure* boundary by maximizing retained earnings and exploring long-term equity financing options to avoid the risk of bankruptcy during times of economic crisis (Altman, 1984).

For investors and capital market analysts, the results of this study emphasize the importance of conducting a comprehensive dual-aspect analysis before investing in a manufacturing company. Investors should not be simply captivated by high sales figures, but should also examine the quality of a company's internal governance through annual GCG implementation reports and monitoring the company's debt-to-equity ratio (DER) (Bushee, 1998). An ideal manufacturing company for long-term investment is one that maintains structural balance: an independent and transparent internal oversight system (strong GCG) while maintaining low to moderate debt levels (healthy DER), thereby generating consistent and sustainable profitability growth (ROA) (Shleifer & Vishny, 1997).

## CONCLUSION

*This study successfully demonstrated that Good Corporate Governance (GCG) mechanisms and capital structure policies play a crucial role in predicting fluctuations in financial performance (Return on Assets) in manufacturing companies listed on the Indonesia Stock Exchange (IDX). The results of a partial quantitative analysis indicate that the implementation of GCG substantively has a positive and significant impact on the efficiency of corporate asset management to generate net profit. Conversely, capital structure policies, as measured by the Debt to Equity Ratio (DER), have been shown to have a negative and significant impact on company profitability. Simultaneously, the integration of good governance and leverage ratio control have a strong contribution in determining the direction of the financial health of the manufacturing sector.*

Theoretically, the findings of this research provide empirical confirmation that strengthens the relevance of *agency theory* and *pecking order theory* in the capital markets of developing countries (*emerging markets*). The positive impact of GCG indicates that tightening the internal supervisory function can reduce agency costs *due* to opportunistic management actions. On the other hand, the negative impact of DER confirms that manufacturing companies with strong profitability tend to prioritize internal funding (retained earnings) to avoid the fixed interest burden of external debt that is prone to eroding profit margins, while also criticizing the overly aggressive application of *trade-off theory* in capital-intensive industries that are sensitive to macroeconomic fluctuations.

Practically, the results of this study recommend that boards of directors and financial managers of manufacturing issuers shift from high-debt-driven expansion strategies to more prudent and optimal capital structure management. Strengthening internal governance is no longer merely a matter of complying with formal administrative regulations, but rather a strategic instrument for building market reputation and lowering the cost of capital. For investors and capital market players, the results of this study emphasize that assessing safe long-term investments in the manufacturing sector requires a combination of two-pronged analysis: selecting issuers with an independent governance oversight system and a track record of measurable and low leverage (debt).

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