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THE EFFECT OF CEO POWER AND CORPORATE GOVERNANCE ON INCREASING FIRMS CREDIT RATINGS

Gusni[1], Mohd Haizam Saudi[2], Roeshartono Roespinoedji[3]*

[1,2,3]Economic and Business Faculty, Widyatama University, Bandung, Indonesia

*[1] gusni.tanjung@widyatama.ac.id

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ABSTRACT

Credit ratings still interesting issue in corporate finance literature as source of information in quickly evaluating of corporate debt securities (bond). The purpose of this study is to investigate the effect of CEO power and corporate governance on firm's credit ratings at financial industry listed in Indonesia stock market for the period 2014 – 2018. This study uses secondary data gather from official website of Indonesia Capital Market and Financial Services Authority with sample is 17 financial firms. This research using ordinal logit regression to explain the effect of CEO power and corporate governance on firm's credit ratings. The result show that CEO power and corporate governance have important role in increase firms credit ratings. Older CEO able to increase firm's quality and push enhancement of credit ratings. Strong corporate governance will increase firm's financial position through step-up of monitoring of management action to promote effective decision making and reduce asymmetry information that can push increase of firm's credit ratings.

INTRODUCTION

Bonds are an alternative source of funding for companies through the capital market to expand productivity by developing companies or intensifying the capital structure to increase the company's competitiveness. Companies will obtain credit from investors through offering and selling bonds in the capital market. To enthrall investors to buy bonds issued by the firm, the company needs to have a good credit rating. A credit rating represents the opinion of a bond-rating agency regarding credit quality and risk that shows a company's overall creditworthiness and ability to pay off its obligations (Ashbaugh-Skaife et al., 2006; Cha et al., 2016). Credit rating enables uninformed investors to conduct quickly assess the risk nature of debt securities issued by various

companies to avoid the default risk. Also, credit ratings can be used by investors as a tool to assess whether debt securities issued by a company fall into the investment-grade or speculative-grade ratings. Bonds that fall into the investment-grade category must have a minimum rating of BBB. Indonesia currently has three bond rating agencies, namely the Indonesian Rating Agency (Pefindo), Fitch Rating Indonesia, and the Indonesian Credit Rating Agency / ICRA (TICMI, 2016).

Credit ratings are affected by several factors, including CEO power and corporate governance (Liu & Jiraporn, 2010; Kuang & Qin, 2013; Bhojraj & Sengupta, 2003; Weber, 2006; Aman & Nguyen, 2013; Altwijry, 2015). The CEO has an important role in a company with a unique background and knowledge that can influence various company policies (Serfling, 2014). CEO has a strong influence on important company decisions (Liu & Jiraporn, 2010). CEO power can lead to a lower corporate credit rating because CEO power can make CEOs act for their interests and benefits (Adams, et al., 2005). CEO strength using CEO age indicates that the level of preference for risk and risk-taking behavior is influenced by CEO age, but the results are still mixed. Young CEOs are seen tend to act safely as a result of their lack of popularity as high-quality managers (Zwiebel, 1995; Holmstrom, 1999). Younger CEOs appear more courageous in investing aggressively and at riskier. If the actions taken have a greater risk, it can lead to a decline in the quality of the company which results in lower credit ratings (Prendergast & Stole, 1996). The strength and experience possessed by the CEO can reduce the cost of bonds that will have an impact on increasing the company's credit rating (Pathan, 2009).

Credit ratings are closely related to corporate governance, which includes mechanisms, processes, and relationships within the organizational structure. Corporate governance can affect credit ratings indirectly by encouraging companies to submit information on time, thereby reducing the risk of misinformation (Bhojraj & Sengupta, 2003). Credit rating agencies are also very concerned about corporate governance because weak corporate governance can lead to breakage to the company's financial position and make bondholders vulnerable to losses (Ashbaugh-Skaife et al., 2006). Every company makes corporate governance one of the important pillars in the company's business activities. Companies that have strong corporate governance are not only able to reduce disputes between company managers and company owners (agency conflict) but also conflict between shareholders and bondholders through increased incentives for decision-makers. It can reduce errors in company management, which in turn will improve the company’s quality and reduce risks for investors and creditors (Aman & Nguyen, 2013; Elhaj, et al., 2017). Several studies suggest that corporate governance has a positive effect on credit ratings (Ashbaugh-Skaife, et al., 2006; Bradford et al., 2019; Alali et al., 2012).

This research was conducted to explain the effect of CEO power and corporate governance on the credit rating of companies in the financial industry listed on the Indonesian capital market for the period 2014-2018 so that it can be seen whether CEO power and corporate governance can affect the increase in firm credit ratings. This study is different from other studies because it uses the CEO power variable, which is measured by using CEO age, which is rarely studied

in Indonesia and fit-out it using the corporate governance variable. The corporate governance practice is still relatively new in Indonesia, so it is interesting to analyze its important role in protecting investors from information manipulation by insiders.

RESEARCH METHOD

This research type is applied research with a quantitative approach. The data used in this study is data taken from the official website of the Indonesian capital market and the Financial Services Authority. The type of data used is secondary data sourced from IDX statistics, financial, company annual, and Financial Services Authority reports. This research also uses the necessary additional information obtained from articles, journals, textbooks, and others. This study combines cross-section and time-series data, also known as panel data. To fulfill the research objectives, companies in the financial industry that issued bonds during the 2014–2018 period on the Indonesian capital market were used in this study with a sample size that had met the criteria set by the purposive sampling technique are 17 companies.

This study uses dependent variables, namely credit ratings and independent variables, namely CEO power and corporate governance with control variables are company size, productivity, and capital structure. All variables along with their measurements and hypotheses can be seen in Table 1:

Table 1. Research Variables, Measurements, Scale and Hypotheses

Research Variables	Measurements	Scale	Hypotheses
Dependent variable			
Credit ratings	Credit ratings scores (AAA=7, AA=6, A=5, BBB=4, BB=3, B=2, C & D=1)	Ordinal	
Independent variables			
CEO power	CEO age	Ratio	H1 (+)
Corporate Governance	Number of commissioners	Ratio	H2 (+)
Control variables			
Firm size	Natural logarithm of total asset	Ratio	
Productivity	Net sales / total asset	Ratio	
Capital structure	Total debt/total equity	Ratio	

In the way to prove the hypothesis proposed in this study, an ordinal logit regression model is used as a tool test. Ordinal logit regression was used on the dichotomous dependent variable, which allows more than two categories of sequential responses. This technique is recommended for the dependent variable, which has several rating values ranging from the lowest to the highest as the firm's credit ratings.

Credit Ratings = f (CEO power, corporate governance, control variables).

RESULTS AND DISCUSSION

Research Results

The fitting information model test results show that by entering the independent variable into the final model, the value changes at a significant level <0.05, which means that the model formed is appropriate. The results of this test are reinforced by the goodness of fit test, which explains the suitability of the model with the data used which indicates that the model formed is appropriate or suitable for use because it has a significant value> 0.05. For more details, see Table 2:

Table 2. The Result of Fitting Information Model and Goodness of Fit Test

Model	-2 Log Likelihood	Chi-Square	Sig.
Intercept Only	244.638		
Final	191.968	52.669	0.000
Pearson		269.97	0.994
Deviance		191.968	1.000

Source: Financial, annual, and financial services authority reports, IDX statistics, processed data

The logit ordinal regression test results as shown in Table 3 describe that CEO power and corporate governance influence on increasing firms credit ratings because they have a significant value <0.05.

Table 3. Ordinal Logit Regression Test Results

Variables	Estimate	Std. Error	Wald	Sig.
CEO Power	-.106	.040	6.856	.009**
Corporate Governance	.995	.170	34.371	.000**
Firm size	-.381	.215	3.128	.077
Productivity	3.371	3.725	.819	.366
Capital structure	.059	.079	.549	.459

*Significant at $p < 0.10$, ** Significant at $p < 0.05$
Source: Financial, annual, and financial services authority reports, IDX statistics, processed data

The coefficient determination of the model test result shown by the Pseudo R-Square shows that the Cox and Snell value is 0.462. It means that the ability of the CEO power and corporate governance variables, as well as the control variables in explaining the company's credit ratings, is 46.2%. While the Nagelkerke and McFadden values respectively -0.489 and 0.215 respectively, which means that the firm’s credit ratings variable can be explained by the CEO power and corporate governance variables and the control variables by 48.9% and 21.5%.

DISCUSSION

CEO has an important role in the company with the background, experience, and knowledge. CEO power shows the strength of the CEO in influencing important company decisions and shaping organizational strategy. The strength of the CEO can be seen from the increasing age of a CEO, which illustrates the increase in experience, and knowledge that will lead a CEO to act wisely in making every strategic decision of the company and taking into account risky decisions that can certainly harm the company. The results of hypothesis testing using logit ordinal regression indicate that CEO power as measured by CEO age has a positive effect on the firm's credit ratings. This condition illustrates that the older a CEO is, the more their ability will be to make the right strategy for the company and make appropriate decisions that can improve the quality of the company, so as to encourage the increase of the firm's credit rating in the financial industry listed on the Indonesian capital market. CEOs who are getting older will be different from CEOs who are still young in making important company decisions. Young CEOs are believed to be unstable in making decisions because of their low knowledge and experience and tend to play it safe (Zwiebel, 1995; Holmstrom, 1999). Young CEOs tend to take more aggressive and riskier investment decisions (Prendergast & Stole, 1996). If they fail, it will cause a decrease in the value of the company, which results in a decrease in the firm's credit rating. Older CEOs are believed to be involved in aggressive, more consistent, and highly loyal earnings management. The results of this study are consistent with the results of research by Liu and Jiraporn (2010) which states that CEO power has an effect on company credit ratings. He further said that strong CEOs are difficult to monitor by bondholders, so they demand higher bond returns. That is why bondholders are attracted to CEO Power.

Corporate governance is a system designed to guide and control a company in order to achieve corporate success and accountability while still paying attention to the needs of stakeholders through making rules and procedures that are in accordance with the law and ethical values (Sutedi, 2012). Every company will always make corporate governance an important pillar in carrying out the company's business activities. Effective corporate governance will be able to supervise and encourage managers to implement values that can reduce agency costs and at the same time show a reduced conflict of interest. This condition will certainly benefit shareholders and bondholders because of the increased cash flow. An increase in cash flow will reduce the occurrence of defaults-risk, which has an impact on increasing company credit ratings (Bradford et al., 2019). The results of the logit ordinal regression test show that corporate governance has a positive effect on increasing the firm's credit ratings. This condition illustrates that corporate governance as measured by the number of boards of commissioners is capable of performing their duties and functions properly, which can encourage the increasing credit ratings of companies in the financial industry listed on the Indonesian capital market. The ability of the board of commissioners to supervise every company's decision-making is in fact able to improve the quality of the company and reduce the risk of default, which has an impact on increasing the firm's credit ratings. Stronger corporate governance will encourage an increase in the company's financial position, which can improve the rating from the rating agency, thereby

increasing the company's credit rating as well as indicating a decrease in the risk of default and misinformation. The results of this study are in line with research performed by Bhojraj and Sengupta (2003), Ashbaugh-Skaife et al. (2006), Bradford et al. (2019) and Alali et al. (2012).

CONCLUSION

This study was conducted to determine the effect of CEO power and corporate governance on increasing a firm's credit ratings in the financial industry listed on the Indonesian Capital Market during the 2014 - 2018 period. The results showed that CEO power had a positive effect on increasing company credit ratings. It means that it is getting older a CEO, the higher the ability of the CEO in managing the company which has an impact on better corporate decision making which can improve the quality of the company and reduce the default risk which will encourage an increase in firm credit ratings. Corporate governance also has a positive effect on increasing corporate credit ratings, which means that the stronger the implementation of corporate governance, the fewer conflicts of interest that occur within the company, both between company managers and shareholders and between shareholders and bondholders. In addition, it can also reduce information asymmetry which can cause moral hazard problems when managers use their power to pursue their personal interests. Stronger corporate governance will become the center of attention of rating agencies that are very concerned with the implementation of corporate governance and become one of the pillars in assessing company credit ratings.

This study still has a number of limitations that affect the study results. First, the limited use of the research sample, only 17 listed companies that issued bonds for the 2014 - 2018 period met the criteria. Thus, the researcher suggests that future studies will use a wider study sample and a longer time-period so that the number of observations is larger and more accurate. Second, this study still uses limited independent variables, so it is suggested to other researchers to use more independent variables in accordance with previous theory and research so that the results of the research produced can contribute more to the development and progress of the financial literature, especially those related to firm credit ratings.

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