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Does Corporate Governance Matter in Decision Making of Stock Repurchases?

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Abstract: This research highlights the stock repurchase motivation in Indonesia and the influence of corporate governance on stock repurchase decision making. Each country has different motivations to repurchase stocks, in which there are six stock repurchase hypotheses. This research also examined the interaction influence of both mechanisms. The market was observed in 6-7 years after melting down the events in 2008-2009. The stock repurchase data were manually collected from the corporate events issued by the companies. The test was conducted based on two corporate governance mechanisms (internal and external mechanisms) which have different tendencies in the corporate governance supervision system. Based on the analysis results, the stock repurchases in Indonesia was motivated to maintain the sustainability of shareholders' authority, especially due to the fluctuating economic conditions signaling the market valuation.

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INTRODUCTION

The focus of this research was to examine the influence of corporate governance on stock repurchase decision making. The previous studies showed that the repurchase sharing decision tended to be different due to the company's performance and how the board understood the company's situation and then planned solutions. In addition, companies in different countries tended to have different motivations to repurchase their shares. For example, Franks *et al.* (2017) conducted a study in Japan where the dominant motivation in repurchasing the company's shares was to restructure the ownership and improve the management quality from the possibility of undirected outside shareholders. On the other hand, the shares repurchased by the US-based companies tended to create financial concessions for the corporate overpayments. Furthermore, companies disguised their financial difficulties by reducing their capital (Lee *et al.*, 2017). We are interested in exploring the situations in which share repurchases are made and the company is managed with certain mechanisms, both internally and externally, so that the share repurchases should be made, especially by the companies in Indonesia. We tried to analyze the determinants of share repurchases measured with the market share values repurchased in the Market Capitalization around the share repurchase announcements.

Many previous studies found that internal and external corporate governance played different roles as oversight and stabilization mechanisms. Internal mechanisms tended to work according to what made the companies stable, either by covering up their problems or by immediately expanding the announcement of the current state, while external mechanisms tended to reveal the company's performance and operation based on legal terms (Caton *et al.*, 2016; Lie & Yang, 2018). Therefore, this study emphasizes how each corporate governance mechanism leads to different share repurchase schemes in Indonesia.

This research has contributed to the stock repurchase and corporate governance literature where the tests were separately performed in both internal and external mechanisms. The role of each mechanism in corporate governance were examined based on the stock repurchase motivation. Most previous studies tested whether or not the companies overperformed or underperformed during the stock repurchase period. Therefore, this study examined the public sentiment and company policies in the related period. This research is expected to provide a comprehensive analysis on how corporate governance affects the stock repurchase policies.

Capital market activity uncertainly moved the outside investors although they should actually not move. Understanding the fundamental aspects of companies and capital market attributes to make the appropriate decisions. Due to the stock repurchase, investors were required to analyze the motivations associated to the corporate events. Therefore, this study revealed the motivation of companies in Indonesia in making stock repurchases. Furthermore, the influence of internal and external corporate governance mechanisms on the decision to make stock repurchases, as well as the interaction influence of these two mechanisms on the decision making.

LITERATURE REVIEW

The motives underlying the decision to withdraw shares varied based on the company's performance and how the board considered the policy. Companies might perform well or poorly, yet the motives to repurchase shares were not limited to the ideal conditions (Lee *et al.*, 2017). Wansley *et al.* (1989) discussed six motivations considered as motives to repurchase the shares: 1) replacing dividends or as a substitute for cash dividends; 2) improving the capital structure by optimizing the company's leverage; 3) reissuing shares when the executive incentives need to be provided; 4) taking advantage of the available cash flows due to the lack of prospective investment opportunities; 5) indicating possibility that the company is undervalued; and 6) transferring wealth from the participating to non-participating shareholders as a method to restructure the ownership components. Although, the reason is for share repurchases, corporate governance studies and post-share repurchases have been widely studied, yet what drives management to repurchase shares is still limited.

Earning management generally occurs around the corporate events. The managers tend to exploit the public reactions to obtain positive abnormal returns even though they need to polish the financial information. The previous studies have reported that stock repurchases abnormally increased stock prices (Cudd *et al.*, 1996; Born *et al.*, 2004; Chandren *et al.*, 2015). The investors' perspective on company performance will be influenced by the information implicitly published through the share repurchase announcements. Cash dividends can convince the market that the company is doing well, but this policy tends to ignore the managers. For example, company payments through cash dividends reflect the conditions which can negatively affect the management incentives (Chen & Lee, 2017).

Because they have provided a positive signal to the market, the dividends are paid and taxed regularly, while the capital reductions through the share repurchases are not taxed and change the cash flow available for investment, by increasing the managerial incentives. In addition, the stock repurchased from the market can be distributed to employees as incentive for their excellence performance, regardless of whether they receive it or not.

One motive to repurchase shares is to optimize the company's performance by reducing the blockholders. A more in-depth study reported by Chen *et al.* (2011) explaining that most companies in China are state-owned companies, Gan (2017) further reported that the intervention of most government ownership can lead to inefficiency of company performance, yet these companies tend to have more stable dividend payout policies (Gugler, 2003). State-owned companies, in some cases, are also considered managers-controlled companies when the managers were previously the members of government and potentially create the principal-agent problems. In addition, Gugler (2003) reported that companies with high centralized ownership can be understood failure to control the company's financial system. By observing the share repurchases in Japan, Franks *et al.* (2017) argued that the increasing firm ownership can also protect the firms from uncertain management of the outside shareholders and bring stability during the financial difficulties. Share repurchases can reduce the blockholders and be a positive signal for the market.

The research conducted by Chen and Lee (2017) reinforced the fact that corporate governance played an important role in repurchasing shares. Previous research reported that better-managed companies tended to concern more on both internal and external shareholders. Companies with dualism tended to repurchase shares in managing the flow of wealth and transferred them to the company members (Chen & Lee, 2017), so that the possibility of the arising agency problems is high. Although corporate dualism can lead to negative responses from the market and shareholders, it can be mitigated by empowering the independent board members. However, the higher the presence of an independent board, the less the company spends the capital expenditure. Therefore, the corporate governance component is pointed in a different direction in response to the share repurchases.

The corporate payout policy cannot be performed unless both parties agree, although most of the time, the dominant corporate action is made due to the insider assistance. The management will highly consider actions to maximize the value of company and share repurchases will improve the company's stock performance. Stock performance will also emerge when the company has a proper monitoring from the outside mechanisms, either from blockholders or independent boards. On the other hand, even though a company is led by competent managers and a member of the board of directors or president director, the market will respond negatively.

METHODS

The data required in this study were obtained from the companies listed on the Indonesia Stock Exchange announcing share repurchases in 2015-2018, 6-7 years after the melting-down events in 2008-2009 to maintain stability after the global crisis (Reinhart & Rogoff, 2014). We limited the data by excluding the companies in the financial industry. The data were taken from the OSIRIS database.

This study used the market value of shares repurchased on the market capitalization to measure the company's payment from the share repurchase (SR) events. We also collected the data related to the motivation of companies to repurchase shares by collecting the corporate news around the corporate event of stock repurchase and annual reports. SR was influenced by loss as a dummy variable defined as 1 for companies reported having negative net income in the previous fiscal year, and 0 if the SR was not made to resolve the financial difficulties (Altman, 1986; Brochet, 2010). For data analysis, OLS was conducted to observe how the internal and external mechanisms of corporate governance played a role in making the share repurchase decisions. Furthermore, we also examined the interaction influence of two mechanisms to determine whether or not the share repurchase decisions equally accommodated both mechanisms. We tested our hypothesis with the regression analysis using the following equation:

$$SR = \alpha + \beta_1 Internal + \beta_2 External + \beta_3 Internal * External + \gamma CV + Fixed\ Effects + \varepsilon$$

This study measured the internal mechanism of share repurchase events using board structure, ownership structure, capital expenditure, and dividend payout policy, while the external mechanism was measured using capital market supervision, investor type, and public sentiment. In addition, we included firm size, book leverage, takeover, and tax (Caton *et al.*, 2016) as control variables.

RESULTS AND DISCUSSION

Data Description

The research data were taken from the companies repurchased the shares in 2016-2018. There were 52 share repurchase events in the related period, but there were only 22 events completing the data could be obtained, especially the disclosure of reasons for implementing the share repurchases by the concerning companies.

Table 1 presents the description of data used in this study. Most companies repurchased the shares in the period of 2016-2018 due to the poor stocks or company performance (Hypothesis 5). These happened due to the unstable market conditions in 2017 or significant stock price fluctuations. Many companies eventually anticipated this by withdrawing their shares to maintain a fair share value so that the value for shareholders and their trust were well maintained.

The share repurchase performance was measured using the stock Performance to figure out how much the companies withdrew their shares from those circulating in public. Of companies making the share repurchases during the related period, most of them made massive share withdrawals. The average number of shares repurchased started from 21.29% to 57.54% of the outstanding shares and based on the review on the companies' annual reports. Some companies planned to hold their shares for 3 years before releasing them once again to the capital market.

Table 1. Research Data Description

Variable	Min	Mean	Max	STD	Kurtosis	Skewness
Hypothesis	2	5 (Fashion)	6	1.4572	-1.2366	-0.3605
Buyback	0.0288	0.2129	0.5754	0.1455	0.0829	0.7642
%IND	4.6512	19.3588	33.3333	8.7690	-0.9658	-0.0488
%INDCOMP	0	5.2652	25	9.1337	0.1567	1.3459
BSize	9	20.2272	49	10.6901	1.5322	1.4064
Block	0	0.5455	1	0.5096	-2.1682	-0.1962
DUO	0	0.8182	1	0.0842	1.2496	-1.7732
Div	0	0.8636	1	0.3513	3.4981	-2.2776
Firm Size	19.7621	22.7211	27,4104	1.7259	1.8064	0.7727
loss	0	0.1364	1	0.3513	3.4981	2.2776
Tax	0.0002	0.2525	0.8253	0.1921	2.5908	1.1977

Furthermore, the internal mechanism of corporate governance in this study was measured using BSize, %IND, %INDCOMP, DUO, Blockholder, and Dividend Payout. Most companies in this study had 23 board directors with the largest number of 49 people. From a total of 22 corporate events, the average number of independent directors was 19.3588% (%IND), while the independent parties as the board members in the compensation section were only 5.2652% (%INDCOMP). This meant that the company's payout policy decisions still predominantly depended on internal conditions and decisions. Some companies used in this study had the blockholders as shareholders (Blockholder=0.5455) and mostly had a CEO and the other divisions (DUO=0.8182). In addition, the companies used as samples in this study distributed cash dividends before the implementation of share repurchases. This indicates that the share repurchases in Indonesia were not made to avoid the distribution of dividends or the first hypothesis of share repurchase in accordance with the result of research conducted by Wansley *et al.* (1989).

Furthermore, in testing the hypothesis, this study used Firm Size, Loss, and Tax as control variables. Most companies used as the samples in this study had an average total asset of IDR

51,343,072,309,8571. This was also reinforced by the fact that most companies did not suffer losses in the previous period (average loss of 0.1364) and the Tax paid by the companies in the previous year was quite large with an average percentage of EBIT reaching 25.25% and some others even reached 82.53%.

Correlation Test Results

Table 2 presents the correlation test results of related to the variables used in this study. From Table 2, it can be clearly seen that BSIZE, %INDCOMP, DUO, Div, Firm size had a negative correlation with the decision to implement the share repurchases. In other words, the more the number of board of directors, independent commissions in the compensation section, CEO with other positions and larger company, the smaller the possibility of implementing the share repurchase policy as a dividend payout. In addition, the cash dividend payment in the previous period also indicates that the possibility of implementing the share repurchase as a substitute for lower cash dividend payment (Div = -0.6025).

Table 2. Correlation Test

	Buyback	*BSIZE*	*%IND*	*%IND COMP*	*Block*	*DUO*	*Div*	*loss*	*Firm size*	*Tax*	*Hypot hesis*
Buyback	1										
BSIZE	-0.1156	1									
%IND	0.1799	-0.1598	1								
%INDCOMP	-0.4062	0.3891	-0.0307	1							
Block	0.1693	0.0810	0.1736	-0.0155	1						
DUO	-0.1992	0.0780	0.2519	0.2781	-0.1936	1					
Div	-0.6025	0.2116	0.0430	0.2344	-0.3627	0.1561	1				
Loss	0.2194	0.1562	-0.4342	-0.0489	-0.1693	0.1873	-0.2281	1			
Firm size	-0.3043	0.5633	0.2761	0.3573	0.1404	0.2642	0.2819	-0.0657	1		
Tax	0.2532	0.1678	-0.3908	-0.0251	0.0640	-0.0185	-0.1450	0.2358	-0.4236	1	
Hypothesis	0.3818	-0.1396	-0.4102	-0.4531	0.0874	-0.4515	-0.4271	0.3341	-0.2033	0.3060	1

On the other hand, the amount of tax (0.2532) and the loss in the previous period (0.2194) could motivate the management to repurchase shares, where this correlation also applied to the reasons for companies in Indonesia to repurchase shares. Supported by Andriosopoulos and Lasfer (2015), it was interesting that the existence of an independent commission in the board of directors and the compensation section equally had a strong correlation to the reasons for repurchasing shares but in different directions. Therefore, there was no restriction on the attributes of capital market activities.

Hypothesis Testing Results

Table 3 presents the research data analysis results to figure out how the internal mechanisms of corporate governance affected the decision to repurchase shares (Hypothesis) and how the performance of company's shares during the repurchase period was. From the analysis results, it could be seen that the more independent committees on the board of directors, the better the stock performance in the repurchase period. This could be seen from the %IND test results with the t-stat of 2.6679 and p-value of 0.0205. Similar results were also obtained from testing the company's cash dividend payout policy. From the data analysis results, it could be seen that the company distributed cash dividends before the repurchase period.

Furthermore, by examining the reasons for implementing share repurchases, it was found that when a company had a CEO with other positions, the company tended to repurchase the shares to improve the company's capital structure and or to implement the share incentives for managerial (t-stat DUO = -

2.1867 with p-value 0.0493). On the other hand, the larger the company, the implementation of share repurchases tended to be based on the interests by increasing more profitable investment opportunities and or maintaining the shareholders' trust.

Table 3. Data Analysis Results

	Buyback	***Hypothesis***
	-0.5014	-5.6230
Intercept	(0.9873)	(-1,6671)
	0.0027	-0.0385
BSIZE	(0.7524)	(-1.6434)
	0.0099	-0.0289
%IND	(2.6679)**	(-1.1676)
	-0.0032	-0.0343
%INDCOMP	(-1.0405)	(-1.6765)
	-0.0347	-0.2214
Block	(-0.5992)	(-0.5748)
	-0.0977	-1.1155
DUO	(-1.2724)	(-2.1867)**
	-0.1977	-0.8345
Div	(-2.3236)**	(-1.4765)
	0.1204	0.5885
Loss	(1.3567)	(0.9988)
	-0.0137	0.3624
Firmsize	(-0.5529)	(2.2032)**
	0.1861	2,2960
Tax	(1.0573)	(1.9643)*
Adj-R2	0.4274	0.4651
F-test	2.7418**	3.0290**

CONCLUSION

The previous studies suggested that there were six hypotheses of companies repurchasing shares and those in different countries had different characteristics or reasons for repurchasing shares (Wansley *et al.*, 1989; Lee *et al.*, 2017). In Indonesia, most share repurchases were made because the companies wanted to maintain the shareholders' trust when the economic conditions were unstable. So, it was predicted that the companies' share values would decline. In addition, for larger companies, they tended to do so to improve the capital structure and held their treasury shares of no more than 3-4 years before releasing them back to the stock market. In assessing the performance of stock prices during the repurchase period, the existence and role of an independent commission in the board of directors and the cash dividend payout policy will determine both shares to withdraw and market to assess the performance of company shares. The percentage of shares institutionally owned by the inside parties and the corporate governance external mechanisms will still be tested in this study in the following test. Due to limited time and data, the collected samples were greatly limited, so that in the next test, the research samples will be further added.

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