

ISLAMIC ETHICAL INVESTMENT AS MECHANISM TO MITIGATE AGENCY CONFLICT: An Empirical Study in Indonesian Stock Exchange

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Abstract

This paper attempts to investigate whether Ethical Investment (EI) could reduce the role of dividend and debt in reducing agency conflict between controlling and public shareholders in Indonesia. I investigate market reaction when EI and Non-EI stocks announce dividend payments, dividend non-payments, and bond issuance. I also investigate the effect of EI and the interaction between EI and dividend and between EI and debt on company's value. The smaller market reaction shows that EI stocks contain less surprises, since EI stocks are able to reduce information asymmetry, and increase trust among investors. The empirical results show that market reaction for debt issuance is less positive for EI stocks than for Non-EI stocks. Regression analysis shows that EI strengthens the role of debt in increasing company's value. The role of EI in reducing agency conflict seems to have multi-dimensions. Event studies show that debt could be used as a substitute for debt in reducing agency conflict, but regression result shows that EI complements debt in reducing agency conflicts, and increase company's value. Overall I conclude that EI provide an important role as mechanisms to reduce agency conflict, and increase company's value.

[Artikel ini menelisis apakah Ethical Investment (EI) dapat mengurangi peran dividen dan bunga dalam menekan konflik perusahaan antara manajer dan pemilik saham publik di Indonesia. Reaksi pasar akan dilibat ketika stok EI dan non-EI mengumumkan dividen dibayarkan, dividen tidak

dibayarkan, dan bon pengeluaran. Hal lain yang juga dilihat adalah pengaruh dari EI dan interaksi antara EI dan dividen serta antara EI dan hutang pada nilai perusahaan. Reaksi pasar yang lebih kecil menunjukkan bahwa stok EI tidak banyak mengejutkan, karena stok EI dapat mengurangi ketidaksinkronan informasi sekaligus meningkatkan kepercayaan investor. Analisis lapangan menunjukkan bahwa pengumuman tentang hutang perusahaan memiliki dampak kurang positif pada stok EI daripada non-EI. Sedangkan analisis regresi menunjukkan bahwa EI memperkuat peran hutang dalam meningkatkan nilai perusahaan. Sementara itu, peran EI dalam menekan konflik perusahaan tampak memiliki banyak dimensi. Secara umum dapat disimpulkan pula bahwa EI memiliki peran yang cukup penting dalam mekanisme untuk menekan agency conflict dan meningkatkan nilai perusahaan.]

Keywords: Ethical Investment (EI), agency conflict, *Daftar Efek Syariah* (DES)

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A. Introduction

Conflict in corporation can be classified into two forms: agency conflict and non-agency conflict. In Finance, the term of agency conflict is well known to describe conflict between manager and principal (owner). Non-agency conflict refers to conflicts related to company's activities. Company's activities could result in conflict with other related parties, either directly or indirectly.

Agency conflict could arise from separation between ownership and control in company, which results in conflict between owners and managers.¹ In later development, agency conflict in company involves other parties, such as bondholders, creditors, controlling shareholders, and other stakeholders. These stakeholders have their own interests, depending on their objectives, but may conflict with other stakeholders'

¹ Jensen, M.C. and W.H. Meckling, "Theory of the Firm: Management Behavior, Agency Costs and Ownership Structure," *Journal of Financial Economics*, October 1976, pp. 305-360.

interests.² Each stakeholder may have different pay off and risks. These asymmetric payoff and risks could also result in conflict among stakeholders. There are some evidence of agency conflict, such as free cash flow agency conflict,³ debt agency conflict,⁴ and conflict between controlling shareholders and public shareholders.⁵

Non-agency conflict arises from company's activities that may have adverse impact and conflict with other parties, both internal and external parties. These parties include employees, suppliers, customers, society, and company's environment.⁶ Several authors argue that objectives and activities of company are not consistent with values of religion,⁷ result in pollution and destruction of environment,⁸ and conflict with values of humanity.⁹

Various Corporate Governance mechanisms¹⁰ could be used to

² Jie Hu, Thomas H. Nu, "Insider Trading and Managerial Incentive," *Journal of Banking and Finance*, 2001, pp. 681-716.

³ Jensen, M.C., "Agency Cost of Free Cash Flow, Corporate Finance and Takeover," *American Economic Review*, May, Vol. 76, No. 2, 1986, pp. 323-339

⁴ Jensen, M.C. and W.H. Meckling, "Theory of the Firm".

⁵ Benjamin Mauri and Annete Pajuste, "Multiple Large Shareholders and Firm Value," *Journal of Banking and Finance*, 2005, pp. 1813-1834; Andrei Shleifer and R.W. Vishny, "A Survey of Corporate Governance," *The Journal of Finance*, Vol. LII, No. 2, June 1997, pp. 737-783; Juzhong Zhuang, et.all, *Corporate Governance and Finance in East Asia- Study of Indonesia, Republic of Korea, Malaysia, Philippines and Thailand*, Asian Development Bank, Manila.

⁶ Jeffery Heinfeldt and Richard Curcio, "Employee Management Strategy, Stakeholder-Agency Theory, and the Value of Firm," *Journal of Financial and Strategic Decisions*, Volume 10 Number 1 Spring 1997; Canice Prendergast, "Consumers and Agency Problem," *Working Paper 8445*, 2001 (<http://www.nber.org/papers/w8445>)

⁷ Laurence Iannaccone, "Introduction to the Economics of Religion," *Journal of Economic Literature*, vol. 36, November 1998, pp. 1465-1496.

⁸ Munoz, Maria Jesus -Torres, Maria AŁ ngeles Fernandez-Izquierdo and Maria Rosario Balaguer-Franch, "The social responsibility performance of ethical and solidarity funds: an approach to the case of Spain," *Business Ethics: A European Review*, Volume 13 Numbers 2/3 April/July 2004, pp. 200-218.

⁹ M. Murningham. *Corporation and Social Responsibility: a Historical Perspective* (New York: Henry Holt and Company, 1992).

¹⁰ Corporate Governance (CG) is known as mechanism to reduce conflict between company and its stakeholders. The coverage of CG includes agency and non-agency conflicts. Agency theory becomes part of CG. In agency thoery, monitoring and bonding are mechanisms to reduce agency conflicts, but several authors include monitoring and bonding as part of CG. Shleifer dan Vishny (1997) include block holder

reduce agency conflict, either through monitoring, bonding, or ethical investment (EI). Dividend and debt policies, which are part of bonding mechanism, are effective mechanisms to reduce agency conflict. In non agency conflict, company that considers and applies religion values, social corporate responsibility, and universal values could reduce conflict between company and its society, its environment, and its other stakeholders.

Debt and dividend policies could traditionally be used as effective mechanisms to reduce agency conflicts. Several papers show that dividend and debt mechanisms are effective means in reducing conflict between controlling and public shareholders.¹¹ In developing countries, dividend could be seen in two functions: agency context and legal protection. First, dividend provides more certainty so it could reduce conflict between controlling and public shareholders. Second, dividend could be seen as legal protection, especially for public or minority shareholders.¹² Dividend policy in Indonesia is viewed more as agency hypothesis and used as mechanism to reduce agency conflict.¹³

Debt could improve company's value because debt could reduce ownership as CG mechanism. John dan Sanbet 1998; Guercio, Dann dan Partch (2003); Brook, Handershott dan Lee, (2000) include internal mechanism (board of executives) and external (market for corporate control) as CG mechanisms. Renneboog (2000) includes ownership, market for corporate control, debt policy as CG mechanisms. Elston dan Goldberg (2003) include concentrated ownership as CG mechanism. Jensen uses four mechanisms in CG, that are board of executives, stock market, regulation, and market factor. Klien (2002); Booth, Cornett dand Tehranian (2003) use composition of board of executives as CG mechanisms.

¹¹ C. And Hansen Crutchly, "A Test of The Agency Theory of Managerial Ownership, Corporate Leverage and Corporate Dividend," *Financial Management*, 18, 1989, pp. 36-46; Klaus Gugler, "Corporate governance, dividend payout policy, and the interest between dividends, R&D, and Capital Investment," *Journal of Banking & Finance* 27, 2003, pp. 1297-1321.

¹² Rafael LaPorta, Florencio Lopez-des-Silanes, Andrei Shleifer, Robert W. Vishny, "Agency Problems and Dividend Policies Around the World," *The Journal of Finance*, Vol. LV, No. 1, 2000, pp. 1-33; Rafael LaPorta, Florencio Lopez-des-Silanes, Andrei Shleifer, Robert W. Vishny, "Investor Protection and Corporate Governance," *Journal of Financial Economics*, 58, 2000, pp. 3-27.

¹³ Todd Mitton, "A Cross Firm Analysis of the Impact of Corporate Governance on The East Asian Financial Crisis," *The Journal of Financial Economics*, 2002, pp. 1-31; Johnson, Simon, Peter Boone, Alasdair Breach, Eric Friedman, (2005), Corporate governance in the Asian 'financial Crisis'," *Journal of Financial Economics* 58, pp. 141-186.

agency conflict. Debt forces managers to avoid unnecessary expenses to improve efficiency.¹⁴ Debt is an effective mechanism, especially if a company faces serious agency conflict.¹⁵ Debt forces controlling shareholders to pay interest and loan repayment, hence not to waste free cash flows.

This paper investigates dividend policy, debt policy, and ethical investment (EI) as mechanisms to reduce agency conflict. I believe that this research will provide significant contribution to agency conflict literature, since investigation of the use of EI as mechanism to reduce agency conflict is relatively new. Most of current literature investigates the use of conventional methods to reduce agency conflict, such as dividend and debt policies. EI could reduce agency conflict, and then potentially could improve company's performance and value, through the decrease of agency conflict.

I define ethical investment (EI) as stocks that meet various syariah standards, which is known as syariah stocks. These standards in Indonesian stock market refer to stipulation of DSN (Dewan Syariah Nasional, or National Syariah Board), number 40/DSN-MUI/X/2003. This research places EI along with dividend and debt mechanisms in reducing agency conflict. In this paper, EI will be used as "moderating variable"; a variable that moderates the effectiveness of debt and dividend in reducing agency conflict between controlling and public shareholders. More specifically, I investigate whether EI decreases or increases the role of debt and dividend in reducing the agency conflict. EI is an effective mechanism to reduce the agency conflict if EI decreases the role of debt and dividend in reducing the agency conflict, and otherwise.

I find that market reactions to dividend announcements for EI and non-EI stocks are negative, suggesting that dividend is not mechanism to reduce agency conflicts. Cross-sectional regression provides weak evidence that EI could reduce the role of dividend in reducing agency conflict. In Indonesian context, this result may not be surprising, since in many corporations, controlling shareholders initiate

¹⁴ Jensen, Gerald, R, (1986), "Agency Cost".

¹⁵ Campbell II, T. L. and Keys, P. Y. "Corporate Governance in South Korea: The Chaebol Experience," *Journal of Corporate Finance*, 8, 2002; James F. Cotter, Sarah W. Peck, "The structure of debt and active equity investors: The case of the buyout specialist," *Journal of Financial Economics* 59, 2001, pp. 101-147

dividend payments. Thus, dividend is not likely used as mechanism to reduce conflict between controlling shareholders and public shareholders. For announcements of bond issuance, I find that market reacts negatively for EI stocks, but positively for non-EI stocks. These results suggest that bond is not used as mechanism to reduce agency conflict for EI stocks, while for Non-EI stocks, bond is used as mechanism to reduce agency conflict. The negative result for EI stocks may also related to the fact that debt level for EI stocks is limited to certain level. An increase to the level beyond certain level is bad news for EI stocks. These stocks will be likely removed from list of Syariah stocks. Furthermore, cross-sectional regressions support my conjecture. In regressions using companies' values as dependent variables, EI decreases the roles of debt as mechanisms in reducing agency conflicts. Regression coefficient for interaction between EI and debt shows negative signs, suggesting that EI moderates the role of debt in reducing agency conflict.

I organize this paper as follows. Section 2 and 3 discusses literature review and hypothesis development. Section 4 discusses research methodology, while section 5 presents empirical findings. Section 6 concludes.

B. Conflict in Corporation

1. Agency Conflict, non-Agency Conflict and Ethical Investment

Agency conflict arises from various parties who have different interests in a company. These parties include managers, owners, controlling shareholders, public shareholders, society, religious parties, and other components of society. In general, there are three types of agency conflicts that are often discussed in finance:¹⁶ First, conflict between managers and principals. This conflict arises from separation between ownership and control in company. Shareholders own the company but delegate their control to managers.¹⁷ Second, conflict

¹⁶ Kose John, Lemma W. Senbet, "Corporate governance and board effectiveness," *Journal of Banking & Finance* 22, 1998, pp. 371-403.

¹⁷ A. A. Berle and G.C. Means, *The Modern Corporation and Private Property* (New York, NY, Harcourt, 1932); M.C. Jensen and W.H. Meckling, "Theory of the Firm"; Andrei Shleifer and R.W. Vishny, "A Survey of Corporate Governance," *The Journal of Finance*, Vol. LII, No. 2, June, pp. 737-783 and see Crutchly, C. And Hansen 1989, "A

between shareholders and bondholders. These parties have asymmetric payoff. Whereas shareholders have payoff related to company's value, bondholders have fixed claim over company. This pattern creates agency conflict that is usually called *agency cost of debt*.¹⁸ Third, conflict between controlling and public shareholders. This conflict arises if controlling shareholders try to expropriate public shareholders.¹⁹

Other conflict in corporation is called non-agency conflict. This conflict arises if company's activities are not consistent with the interests of other stakeholders (not just shareholders). These stakeholders include employees, customers, suppliers, religion values, society, and environment.²⁰

2. Sources of Conflict in Corporation

There are various sources that may cause agency conflict: First, asymmetric information between principals and managers. Managers possess better information about company than principals. Asymmetric information may also exist in the relationship between controlling and public shareholders, as well as between shareholders and bondholders.²¹ Second, free cash flow in corporation. Managers want to keep free cash flow rather than distributing free cash flow to stockholders.²² Third, different view of risks between principal and managers.²³ Shareholders (principal) tend to choose investment with high risk with expectation to obtain higher profit. However, managers tend to choose investment

Test of The Agency Theory", 1997, pp. 36-46.

¹⁸ Andrei Shleifer and R.W. Vishny, "A Survey of Corporate Governance," *The Journal of Finance*, Vol. LII, No. 2, June, 1997, pp. 737-783; C. Crutchly and Hansen, "A Test of The Agency Theory."

¹⁹ Benjamin Mauri and Annete Pajuste, "Multiple Large Shareholders and Firm Value," *Journal of Banking and Finance*, 2005, pp. 1813-1834.

²⁰ Jeffery Heinfeltd and Richard Curcio, "Employee Management Strategy"; Canice Prendergast, "Consumers and Agency Problem," *Working Paper*, 2001 (<http://www.nber.org/papers>, pp. 1071-1102)

²¹ Timothy Brailsford and J. Daniel Yeoh, "Agency Problems and Capital Expenditure Announcements," *Journal of Business*, vol. 77, no. 2, 2004, pp. 223-256.

²² M.C. Jensen, "Agency Cost."

²³ Katheleen, M. Eisenhardt, "Agency Theory: An Assessment and Review," *Academy of Management Review*, 1989.

with low risks. Fourth, difference in time horizon between managers and stakeholders.²⁴ Stakeholders tend to choose investment with longer time horizon with expectation to get higher profit. However, managers tend to choose investment with shorter time horizon.

Factors that cause non-agency conflict mainly come from company's activities that are considered inconsistent with ethical values. Several investments, such as investing in riba activities, exploiting humans and environments, are considered inconsistent with values of certain religious teachings, so the investments have to be excluded from group of ethical investments.²⁵ Corporate activities that result in conflict with its stakeholders will also create non-agency conflicts. Thus corporates that neglect its environment will be viewed as having high degree of non-agency conflicts, while corporates that are environment friendly will be viewed as having low degree of non-agency conflicts.²⁶ The same situation holds for companies that have conflicts with consumers, employees, suppliers, and other stakeholders, since these companies neglect their rights.²⁷

3. *Ethical Investment (EI)*

EI is a combination between business and certain values to reach broader objectives, which are financial and non-financial gains. Criteria for ethical investments are highly influenced by each country condition and basic values affecting the investment. The definition of ethical investment has been developing. The definitions below emphasize more on social aspect in investment rather than other business aspects.

The United Kingdom Social Investment Forum (UKSIF) defines ethical investment more broadly: *Investment that enables investors to combine financial objectives with their social values, links investors to the areas of social*

²⁴ Patrick McColgan, "Agency Theory and Corporate Governance," *Working Paper*, 2001.

²⁵ Sam Hakim, Manochehr Rashidian, "Risk and Return of Islamic Market Indexes," *un-published paper*; Hellsten, Sirkku, Chris Mallin, "Are Ethical or Socially Responsible Investments Socially Responsible," *Journal of Business Ethics*, 2006, pp. 393–406; Grant Michelson, Nick Wailes, Sandra van der Laan, "Ethical Investment Processes and Outcomes," *Journal of Business Ethics* 52, 2004, pp. 1-10.

²⁶ D. Wood, "Corporate Social Performance Revisited," *Academy of Management Review* 16, 1991, pp. 691-718; Maria Jesus Munoz, et al., "The social responsibility."

²⁷ Canice Prendergast, "Consumers and Agency Problem."

*justice, economic development, peace and the environment.*²⁸ Cowton defines EI as investment decisions which are based on social and ethical values as their objectives.²⁹ Another definition is provided by Heese: *EI is an investment that uses social values as its financial objective.*³⁰ The development of ethical values from various countries shows that criteria for EI are drawn from various sources: religion, corporate social responsibility, environmental issues, and universal values.

This research uses EI based on Islamic values. In Indonesia, Islamic values in the economy are implemented through decree of National Syariah Council (NSC) of Indonesian Ulema Council (IUC). The decree states that the business or the objects of the business have to meet criteria established by NSC of IUC, and Capital Market and Financial Institutions Supervisory Board (Bapepem-LK), which is summarized in NSC of IUC fatwa, number: 40/DSN-MUI/X/2003, on Capital Market, and General Guidance on the application of Syariah Principles in Capital Market. This general guidance is followed by Bapepam-LK rule number: KEP-130/BL/2006 about the issuance of syariah securities. The rule provides general considerations on business that conflict syariah principles. These businesses include: 1) Gambling and activities that could be classified as gambling or forbidden business. 2) Financial services that apply riba (usury, interest), trading activities that have gharar (uncertainty) and maysir (speculation) elements. 3) Production, distribution, trades, or providing: (a) Goods and services that are forbidden because of its substance (haram li-dzatihi); (b) goods and services that are forbidden, because of outside of its substance (the substance is halal), and are stipulated by Indonesia Ulema Council, and (c) goods and services that damage moral. 4) Investing in company that have more dominant debt level than its capital, from financial institutions that apply usury business, except for companies that have been certified its 'syariahness (legalistic)' by

²⁸ J. Elkington, *Cannibals with Forks. The Triple Bottom Line of 21st Century Business* (Oxford: Capstone, 1999).

²⁹ Christopher J. Cowton, "Playing by the rules Ethical: criteria at an ethical investment fund," *Journal Business Ethics: A European Review*, Volume 8 Number, January 1999, pp. 60-69.

³⁰ Karen Heese, "The Development of Socially Responsible Investment in South Africa: experience and evolution of SRI in global markets," *Development Southern Africa* Vol. 22, No.5, December 2005, pp.729-739.

Indonesia Ulema Council.

The Bapepam-LK rule is followed by regulation number: KEP-314/BL/2007, about the criteria and issuance of syariah stocks, which states that syariah stocks should have the following: 1) Total interest-based debt over total equity does not exceed 82%, or the ratio of interest-based debt over total equity does not exceed 45%, and 2) Total interest income and other illicit income over total income (revenue) do not exceed 10%.

These criteria along with general consideration mentioned above set the requirement for syariah stocks. I use these criteria to classify stocks either as syariah or non-syariah stocks.

C. Literature Review and Hypotheses Development

1. *Agency Conflict, Dividend Policy, and Ethical Investment (EI)*

Mechanisms to reduce agency conflicts include various means, such as dividend, debt, as well as policies in composition of board of executives and commissioners. Dividend policy is one of many mechanisms to reduce agency conflict between controlling and public shareholders. Moreover, La Porta, et al. show that high dividend payment is another form of protection for public shareholders.³¹ Mutamimah strengthens La Porta et. al by showing that dividend policy is an effective mechanism to reduce conflict between controlling and public shareholders, in companies with highly concentrated and those with less concentrated ownership.³² Faccio, et al. show that increases in dividend will restrict controlling shareholders' actions that do harm to public shareholders.³³

I introduce Ethical Investment (EI) as a complement to dividend policy as mechanisms to reduce agency conflict. Beal et. al (2005) show that investment in ethical companies provides financial gains, as well

³¹ Rafael LaPorta, Florencio Lopez-des-Silanes, Andrei Shleifer, Robert W. Vishny, "Investor Protection and Corporate Governance," *Journal of Financial Economics* 58, pp. 3-27.

³² Mutamimah, "Kebijakan Dividen, Utang dan Investasi sebagai Mekanisme Pengurang Konflik Keagenan antara Pemegang Saham Mayoritas dengan Minoritas," Ph.D Dissertation at UGM, 2006.

³³ Mara Faccio, Lary HP, Lang and Young Leslie, "Debt and Expropriation," *Working Paper*, pp. 1-35.

as non-financial gains, and is consistent with social values.³⁴ Investors of EI require that board of executives has ethical perspective and has to pay attention to investor and all stakeholder's interests.³⁵ Activities of EI company have orientation for sustainability and disclosure for all stakeholders, and are part of Corporate Governance.³⁶ This condition could reduce conflict in corporation by minimizing information asymmetry and improve company's performance.³⁷ The mechanism of EI as Corporate Governance is expected to improve investors' trust to company, and decrease their expectation for dividend in reducing agency conflict. The lesser demand for dividend to reduce agency conflict for EI companies will result in lower investors reaction for EI companies than that for non EI companies. In such situation, I expect that EI mechanism would reduce the effectiveness of dividend policy in reducing conflict between controlling and public shareholders. I develop my first hypothesis as follows:

H1: *Ethical Investment weakens the effectiveness of dividend policy as mechanism in reducing agency conflict between controlling and public shareholders.*

2. Agency Conflict, Debt Policy, and Ethical Investment

Debt policy is one of Corporate Governance mechanisms that could reduce conflict between controlling and public shareholders. Debt will be followed by periodic interest and principal payments that could reduce free cash flow. The payment could signal that controlling shareholders do not use cash flow to their advantage. Also, with high payments, managers will be forced to increase efficiency and improve

³⁴ Beal, Diana J., Michelle Goyen, and Peter Phillips, (2005), Why Do We Invest Ethically?, *The Journal of Investing*, Fall, pp. 66-77

³⁵ Rodger Spiller, "Ethical business and investment: A model for business and society," *Journal of Business Ethics*, Sept. 2000.

³⁶ Ans Kolk, "Sustainability, Accounting and Corporate Governance: Exploring Multinationals' Reporting Practices," *Business Strategy and the Environment*, the KPMG International Survey of Corporate Responsibility Reporting 2005, pp. 1-18.

³⁷ C.C. Verschoor, "A Study of The Link Between as Corporation's Financial Performance and Its Commitment to Ethics," *Journal of Business Ethics*, 17, 1998, pp. 1509-1516.

investment decisions. Debt could be used effectively as mechanism to reduce conflict between controlling and public shareholders, as well as mechanism to improve company's efficiency.³⁸

In several countries, researches on debt policy yield mixed results. Debt level in Indonesia is already high.³⁹ Debt increase will create new conflict between shareholders and bondholders. Debt policy in such situation could harm creditors and public shareholders, especially in countries with low legal protection, poor corporate governance, and weak legal protection.⁴⁰ The high debt level in Indonesia may result in additional debt not as a means to reduce agency conflict, but instead a vehicle to create new conflict, or to increase agency conflict. In such situation, we can expect to have negative market reaction for debt increase.

EI mechanism could be used to complement debt mechanism as a means to reduce agency conflict for several reasons. First, syariah criteria in Indonesia requires that to be included in the list, company must maintain its ratio of total interest based debt over total equity not to exceed 82%, and the maximum proportion of total debt to total equity is 45%. This restriction is expected to have impact on company's performance and to minimize bankruptcy risk, thus adding value to EI stocks. Second, as argued before, syariah criteria can be expected to increase investor trust on the company. Improved trust could be expected to reduce cost of capital. Investor reaction to debt policy could be expected to decrease when investor trust for the company is high. EI mechanism could improve performance and reduce conflict with society, environment, and religion. I develop second hypothesis as follows:

H2: *EI weakens the effectiveness of debt as mechanism in reducing agency conflict between controlling and public shareholders.*

³⁸ Timothy J. Brailsford and Daniel Yeoh, "Agency Problems and Capital Expenditure Announcements," *Journal of Business*, vol. 77, no. 2, 2004, pp. 223-256.

³⁹ Se-Jik Kim and Mark R. Stone, "Corporate Leverage, Bankruptcy, and Output Adjustment in Post-Crisis East Asia," *IMF Working Paper*, October 1999, pp. 1-29

⁴⁰ Rafael LaPorta, et al. "Investor Protection.," Atanasov, Vladimir, "How much value can blockholders tunnel? Evidence from the Bulgarian mass privatization auctions," *Journal of Financial Economics* 76, 2005, pp. 191-234.

D. Data and Fact Findings

In 2003, Supervisory Board of Stock Market signed an MOU with DSN-MUI to select syariah stocks in Indonesia. PT Danareksa, Jakarta Stock Exchange, and MUI work together to develop list of syariah stocks. Stocks listed in Jakarta Stock Exchange are selected using syariah criterion to be included in the list of syariah stocks. On July 3, 2000, list of syariah stocks was introduced. I use the standards to develop my own list of syariah stocks.⁴¹

I then select companies from year 2000-2007 that pay dividend and do not pay dividend, and also issue bond. Using the list of Syariah stocks I develop, I categorize the sample into two groups: Syariah investment or Ethical Investment and Non-Ethical Investment. I define dividend paying and non-paying stocks as stocks that pay dividend and those that stop paying dividend relative to previous year (in previous year stocks pay dividend, while in current year, stocks do not pay dividend). Stocks can be counted more than one in my sample. Table 1 shows the distribution of the sample. For EI stocks I collect 293 stock years, while for Non-EI stocks, I collect 254 stock years.

Table 1. Distribution of Stocks in the Sample

	Non-EI stocks	EI stocks
Sub-total dividends-non payment dividend stocks	244	261
Pay dividend	131	176
Do not pay dividend	113	85
Issue bond	10	32
Total stocks	254	293

⁴¹ The standards are developed from DSN-MUI which are translated into Stipulation of Chairman of Stock Market Supervisory Board and Financial Institution, number: KEP-130/BL/2006 and appendix number: IX.A.13 and stipulation number: KEP-314/BL/2007, and appendix II.K.I.

2. *Variables Definition*

Dependent variables in this research are market reaction and company's value. I use standard event study methodology to calculate market reaction around events of announcements of dividend payments and non-payments, and bond issuance. The event date for dividend announcements is the date of shareholders meeting, when company announces dividend distribution or do not pay dividend. For bond issuance, I use the date when company announces bond issuance. I calculate average abnormal return (AAR) and cumulative average abnormal return (CAAR) around event date, defined from days -10 to days +10 relative to event date.⁴² Abnormal return is calculated as stock return minus market return (market adjusted abnormal return). For company's value, I use modified Tobin's Q, proxied as follows: $(\text{Market Value of stocks} + \text{Book Value of Debt}) / \text{Total Book Value of Assets}$. I use the same fiscal values for these variables.

I use dividend pay out ratio (dividend per-share divided by earning per-share) for dividend policy, and total debt over total equity as proxy for debt level. EI is proxied by list of Syariah Securities screened by the Syariah criteria.

I use size as control variable. Size is well known to have effect on company's performance. Moreover, larger company tends to pay higher dividend and have higher debt level. Size is proxied by market capitalization of company's stocks (market price times number of shares outstanding). I also include ownership concentration as control variable. Ownership concentration is calculated using Herfindhal Index of shareholders with a minimum of 20% holdings.

2. *Descriptive Statistics*

This section starts with descriptive statistics, then proceeds to hypothesis testing. Tables 2 and 3 show descriptive statistics for EI stocks and Non-EI stocks.

⁴² Initially, I define event windows from days -10 to +10. Since it is possible to have information leakage before the event, and it is difficult to locate exactly on which days the leakage occurs, then I calculate event windows that provide the strongest results. For this reason, in this paper, I report different event windows for dividend payment, dividend non-payment, and bond issuance. I thank anonymous reviewer for pointing possibility of information leakage.

Table 2. Descriptive Statistics for EI stocks

	Herfindal Index for Ownership	Company's Value	Dividend	Debt	Long of Size
Mean	11.52	0.77	0.56	1.41	0.44
Std dev	0.94	0.78	1.47	1.55	0.21
Minimum	9.80	0.01	0.02	0.04	0.05
Maximum	15.55	3.83	12.77	11.10	0.87

The above table presents descriptive statistics for the sample. Herfindhal Index is calculated for shareholders with a minimum holding of 20%. Company's value is calculated as Market Value of Stocks plus Book Value of Debt divided by total asset. Dividend is calculated as Dividend per-share divided by Earning Per-Share, Debt is calculated as Debt divided by Total Equity. Size is market price times number of shares outstanding. Negative numbers for dividend and debt are deleted.

Table3. Descriptive Statistics for Non-EI stocks

	Log of Size	Debt	Dividend	Debt	Log of Size
Mean	11.45	1.77	0.34	1.21	0.37
Std dev	0.86	1.20	0.58	0.96	0.22
Minimum	9.53	0.53	0.01	0.58	0.06
Maximum	14.08	10.16	3.97	10.51	0.86

The above table presents descriptive statistics for the sample. Herfindhal Index is calculated for shareholders with a minimum holding of 20%. Company's value is calculated as Market Value of Stocks plus Book Value of Debt divided by total asset. Dividend is calculated as Dividend per-share divided by Earning Per-Share, Debt is calculated as Debt divided by Total Equity. Size is market price times number of

shares outstanding. Negative numbers for dividend and debt are deleted.

Tables 2 and 3 show that ownership concentrations between EI and Non-EI stocks tend to be similar. EI stocks tend to be larger, with larger dispersion, than non-EI stocks. Company's value for EI tends to be larger than that for Non-EI. The higher value for this variable may reflect high future expectation for this group of companies. Dividend pay-out ratio for EI companies tends to be larger than that of Non-EI companies. One possible reason for such finding is that EI companies tend to have better performance. Debt level for EI companies tend to be lower than that for Non-EI companies. This may be a result of Syariah criterion for debt level; Syariah stocks require that debt level (interest based debt over total equity) should not exceed 82%.

E. Ethical Investment and Market Reaction

1. Market Reaction to Announcements of Dividend Payments

Table 4 shows market reaction to announcement of dividend payments. I report average abnormal return in days=0, and cumulative average abnormal return for days -2 to +2.⁴³

Table 4.
Market Reaction To Announcements of Dividend Payment

	EI	Non-EI
CAAR ₂	0.022	-0.052
p-value for CAAR difference	0.0724	

The above table reports market reaction to announcements of dividend payments. The date of announcements is the date of shareholders' meeting. Ethical Investments (EI) are stocks included in List of Syariah Securities. Abnormal return is calculated using market

⁴³ As I mentioned above, I use different periods for the event windows. Thus I report periods of days -2 to +2 for dividend payments, periods of days 0 for dividend non-payments, and periods of days -3 to +3 for debt issuance.

adjusted, that is return minus market return. CAAR2 is cumulative abnormal return from days -2 to +2. P-value is in the last row.

The table shows that average abnormal returns for both EI and Non-EI stocks are difference. Cumulative average abnormal return for EI stocks shows positive number, while that for Non-EI stocks show negative number. The positive reaction for EI stocks is consistent with previous findings for dividend increase or initiation. Negative reaction for Non-EI stocks could be interpreted that dividend paid is less than investors' expectation. This argument is supported by lower level of dividend payment, which is around 0.33 (see table 3 above).

This finding seems to suggest that EI stocks could not mitigate the role of dividend as mechanism to reduce agency conflict. I expect to have less positive market reaction for EI stocks than that for non-EI stocks. Instead, I have positive market reaction for EI stocks (CAAR2 of 0.022), and negative reaction for non-EI stocks (CAAR2 of -0.052). This result may reveal another interpretation. Conversations with several practitioners and anecdotal evidence reveal that, in Indonesia, controlling shareholders usually initiate dividend payments. These shareholders usually demand certain amount of dividend to managers, and then formalized in shareholders' meeting. With such big power, dividend is not likely used as mechanism to control conflict between controlling and public shareholders. Controlling shareholders can ask for dividend practically at any amount they want. New conflict may arise from such practice, that is conflict between controlling shareholders and public shareholders. Dividend payments may exacerbate this conflict, for example, by asking too much dividend which results in less fund available for profitable investments, hence lowering company's value. The explanation above seems to be consistent with our finding above. For non-EI stocks, market reaction is negative, suggesting that agency conflict between controlling and public shareholders may increase. For EI stocks, market reaction is positive, suggesting that the agency conflict is minimized.

2. Market Reaction to Announcements of Dividend Non-Payment

Table 5 shows market reaction to announcements of dividend non-payments. I define dividend non-payment when a company announces

that it will not pay dividend this year, when previous year paid dividend.

Table 5.
Market Reaction To Announcements of Dividend Non-Payment

	EI	Non-EI
CAAR _{t0}	-0.026	-0.002
p-value for CAAR	0.0042	

The above table reports market reaction to announcements of dividend non-payments. Dividend non-payments are defined when company announces not to pay dividend this year, while it pays dividend in previous year. The date of announcements is the date of shareholders' meeting. Ethical Investments (EI) are stocks included in List of Syariah. Abnormal return is calculated using market adjusted, that is return minus market return. CAAR0 is the cumulative abnormal return during days 0. P-value is in the last row.

The table shows that market reactions (CAAR_{t0}) for both EI and non-EI stocks are negative. Cumulative Abnormal Return for EI stocks tend to be smaller than those for non-EI stocks. The difference between CAAR for EI and that for non-EI is significant at 5%.

One possible explanation for negative reaction for dividend non-payment comes from signaling theory. In this case, dividend is used to signal company's future. Dividend non-payment may signal poor future condition; market reacts negatively to announcements of dividend non-payments. The negative reactions apply for both company: EI and non-EI stocks.

Why does market reaction for non-EI stocks have less negative value? The explanation may come from agency theories. Recall from previous subsection, dividend payments may actually increase conflict between majority and public shareholders. The less dividend paid may help reduce this conflict. The less negative value for non-EI stocks suggests that non-dividend payment may actually help non-EI companies, by reducing the negative effect of high dividend payment. Instead of paying out cash as dividend as demanded by majority shareholders,

company can use cash for investment that can add value, and thus beneficial to public shareholders too. This phenomenon may result in less negative effect for non-EI stocks.

3. Market Reaction for Bond Announcements

In this section, I investigate market reaction for announcements of bond issuance. Table 6 shows market reaction to the announcements.

Table 6.

Market Reaction To Announcements of Bond Issuance

	EI	Non-EI
CAAR _{t3}	-0.0327	0.0709
p-value for CAAR difference	0.0344	

This table reports market reaction to announcements of bond issuance. Ethical Investments (EI) are stocks included in List of Syariah Securities issued by Supervisory Board for Stock Market. Abnormal return is calculated using market adjusted, that is return minus market return. CAAR3 is cumulative abnormal return from days -3 to +3. P-value is in the last row.

Table 6 shows that Cumulative abnormal return from days-3 to +3 (CAAR_{t3}) for EI stocks shows negative numbers, while for non-EI stocks shows positive number. Negative reaction for EI stocks indicates that debt is not used as mechanism to reduce agency conflict between controlling and public shareholders. Researches on debt policy yield different conclusions. Debt level in Indonesian is relatively high.⁴⁴ The new debt will create additional conflict between debtholders and shareholders.⁴⁵ Debt policy costs debtholders and public shareholders, especially in countries with weak investor protection.⁴⁶ This condition will likely result in negative response by investors and reduce company's

⁴⁴ Se-Jik Kim and Mark R. Stone, "Corporate Leverage."

⁴⁵ C. Crutchly and Hansen, "A Test of The Agency."

⁴⁶ Mara Faccio, Lary HP, Lang and Young Leslie, "Debt and Expropriation," *Working Paper*, pp. 1-35.

value. Companies in Indonesia tend to have high agency conflict; new debt will increase agency conflict.⁴⁷ Debt policy will do harm to investors if corporate governance is weak, and protection for public shareholders is inadequate.⁴⁸

The negative reaction for EI stocks may also come from ‘practical’ reasons. The syariah standards require company to maintain its debt below certain level. Debt level for EI companies is limited to maximum of 0.82 (interest based debt over total asset), or a ratio of 55:45 between total debt over total company’s net worth. An increase of debt beyond this level may result in removal from the list of syariah stocks. The company will lose many benefits associated with syariah stocks, increase bankruptcy risk; hence market reacts negatively to debt issuance.

The positive market reaction for non-EI stocks supports my conjecture. For non-EI stocks, debt is used as mechanism to control agency conflicts, resulting in positive effect of debt on company’s value. Debt is usually considered a stronger mechanism to reduce agency conflict than dividend.⁴⁹ Principal and interest payments have stronger bonding effect than dividend payment. Company does not an obligation to pay dividend, even when the company earns profit. While the company is obligated to pay principal and interest payments, in any situation. Failure to honor such obligation may result in bankruptcy.

Results from this section support my conjecture. Debt is used as mechanism to control agency conflicts for non-EI stocks. For EI stocks, debt is not used as mechanism to control for agency conflict. Since debt has stronger bonding effect than dividend, I believe that results from debt analysis provide stronger evidence. Hence, the results from this section support my conjecture that EI is used as mechanism to reduce agency conflicts.

⁴⁷ Benjamin Mauri and Annete Pajuste, “Multiple Large Shareholders and Firm Value,” *Journal of Banking and Finance*, 2005, pp. 1813-1834.

⁴⁸ Pramuan Bunkanwanichay, Jyoti Guptaz, Rokoh Rokhimx, “Debt and Entrenchment: Evidence from Thailand and Indonesia,” a draft by September 15, 2003, *JEL Classification: G15, G32, G34*, pp. 1-28.

⁴⁹ M.C. Jensen, “Agency Cost of Free Cash Flow.”

4. *Ethical Investment and Company's Value*

In this section I investigate the effect of EI on company's value using regression analysis. I expect to have consistent results with the investigation using market reaction explained above. First, I examine the effect of EI, dividend, and the interaction between EI and dividend on company's value. I also include control variables: size and stock ownership. Second, I investigate the effect of debt and interaction between debt and EI on company's value. If EI moderates the role of dividend and debt as mechanism to reduce agency conflict, I can expect to have negative coefficients for interaction variables. Specifically, negative coefficients for interaction variables indicate that EI moderates the effect of debt and dividend; EI reduces the role of dividend and debt as mechanism to reduce agency cost.

Tables 7 and 8 summarize my findings. Table 7 reports the effect of dividend and interaction between dividend and EI on company's value. The table shows that while the interaction between EI and Dividend yields sign consistent with the prediction, but the statistical power is non-existent. The coefficient is not significant. Size shows significant positive coefficient; the larger the size, the better the value for the companies.

Table 7.
The Effect of EI, Dividend, Debt, and Interaction Between Dividend and EI on Company's Value

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	-1.85041	0.97674	-1.89	0.0591
EI	-0.17857	0.17754	1.01	0.3154
DIV	0.11935	0.20535	0.58	0.5616
OWN	0.24006	0.36786	0.65	0.5145
SIZE	0.25565	0.08394	3.05	0.0025
IE*DIV	-0.07890	0.21674	-0.36	0.7161
Adj R-Sq	0.0234			
N =	299			

The above table reports regression analysis for the following

model:

$$V = \alpha + \beta_1 EI + \beta_2 Div + \beta_3 Own + \beta_4 Size + \beta_5 IE * Div + e$$

V (company's value) is proxied by Market value of stocks plus book value of debt divided by total assets. Ethical Investments (EI) are stocks included in List of Syariah Securities. Dividend is calculated as dividend per share over earning per share. Own is amount of ownership above 20%. Size is calculated as market price times number of shares outstanding. Negative dividend and debt are deleted.

I further investigate the effect of EI, debt, and interaction between EI and debt, on company's value. Table 8 shows the result. Ownership provides positive and significant coefficient, but at weaker significance level. Size still has the strongest power in explaining company's value. The regression coefficient for size is positive and significant at 1% level. While the coefficients for ethical investment (EI) and debt are not significant, the interaction between EI and debt provides the most interesting result. The interaction between EI and debt yields positive coefficient, and significant at 5%. This result shows that EI strengthens the effect of debt on company's value. The positive coefficient for interaction variable is a 'surprise' since we expect to have negative coefficient. I interpret that debt and EI, instead of having substitute relationship, have complementary relationship. Thus the presence of EI strengthens the effect of debt on company's value. Since EI companies have 'passed' several tests, investors trust them more than non-EI companies. In that situation, debt becomes more valuable in increasing value for the companies.

Table 8.
The Effect of EI, Dividend, Debt, and Interaction between EI and Debt on Company's Value

Prob.	t-Statistic	Std. Error	Coefficient	Variable
0.0040	-2.89	0.76501	-2.21200	C
0.6771	0.42	0.14880	0.06201	EI

0.3791	0.88	0.03258	0.02868	DEBT
0.0680	1.83	0.26772	0.48961	OWN
<.0001	4.31	0.06509	0.28065	SIZE
0.0423	2.04	0.08341	0.16984	EI*DEBT
			0.0615	Adj R-Sq
			505	N =

the above reports regression analysis for the following model:

$$V = \alpha + \beta_1 EI + \beta_2 Debt + \beta_3 Own + \beta_4 Size + \beta_5 IE * Debt + e$$

V (company's value) is proxied by Market value of stocks plus book value of debt divided by total assets. Ethical Investments (EI) are stocks included in List of Syariah Securities. Own is amount of ownership above 20%. Size is calculated as market price times number of shares outstanding. Debt is calculated as total debt over total equity. Negative dividend and debt are deleted.

G. Conclusion

This research attempts to investigate the role of ethical investment (EI) in reducing agency conflict, along with dividend and debt. EI stocks are stocks that have passed several syariah criteria developed by Stock Market supervisory board. These selected or chosen stocks will be trusted more by investors, since they are more likely to have more desirable characteristics, such as low information asymmetry, better conduct, and so on. If these characteristics exist, I argue that agency conflict in these companies will be reduced. If EI could be used to reduce agency conflict, then EI could substitute the role of dividend and debt in reducing agency conflict. Using this argument, I can expect that EI could decrease the role of dividend and debt in reducing agency conflict.

The findings for dividend payments and non-payments do not support my conjecture. I believe that dividend in Indonesian context is not used as mechanism to reduce agency conflict. Further evidence

from regression analysis does not support my conjecture. The interaction variables between EI and dividend have negative coefficients, but insignificant. I believe that debt issuance will provide cleaner and stronger analysis since debt is stronger mechanism to reduce agency conflict. For EI stocks, market reaction to debt issuance is negative, while that for non-EI stocks is positive. However, regression analysis shows that the interaction variable between EI and debt has positive effect on company's value. The result from event study suggests that for non EI stocks, debt is used as mechanism to reduce agency conflict, and it is not for EI stocks. In other words, EI could be used as mechanism to reduce agency conflict. However, result from regression analysis suggests that EI can be used to complement debt in controlling agency conflict. EI could strengthen the role of debt in increasing company's value. Thus, I find an interesting result: EI has multi-dimensions, EI could substitute debt in reducing agency conflict, but EI strengthens the role of debt in increasing company's value. Overall I believe that EI could be used as mechanism to reduce agency cost and increasing company's value.

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