
The Influence of Free Float Shares and Audit Quality on Company Performance: Evidence from Indonesia

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Abstract

This study aimed to examine the effect of the free float of shares and audit quality on company performance in public manufacturing companies listed on the Indonesia Stock Exchange (IDX) during 2013-2016. The sample comprised 80 companies with 320 years-observation and the hypothesis and the relationship between variables were tested with the 3.0. version of Smart-PLS statistical program. The results show that the free float of shares has no significant impact on company performance, while audit quality has a significant positive effect. The results are relevant for regulators, shareholders and other stakeholders, especially in countries with emerging capital markets, such as Indonesia.

Keywords: free float of shares, company performance, audit quality, capital markets

JEL Classification: M42, E22, E23

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1. Introduction

Several studies related to finance and law indicated that in countries that have developed stock markets, company shareholders get efficient protection from the legal systems. In general, in common law countries, the characteristics of corporations with dispersed ownership structures tend to lead to "agency problems" between owners and managers. Whereas countries that have civil law systems tend to feature concentrated ownership characteristics in companies, that can lead to "expropriation problems" (Ararat and Ugur, 2003) between controlling owners and minority shareholders (Bostanci and Kilic, 2010).

Indonesia is a country that embraces civil law. Specific local characteristics and regulations are the right place to study the impact of ownership structure in emerging capital markets. One aspect of the capital market in Indonesia is the fact that it is dominated by the ownership structure of family companies or business groups that offer relatively weak levels of protection for investors. Initially, the company owners were reluctant to offer more shares that they had to the public in order to avoid losing control of the company. It is the reason of the lack of free float in the capital market. The low free float of equity in public companies listed on the stock exchange in civil law countries can be seen as a symptom of the little protection offered to weak investors (Bostanci and Kilic, 2010), and concentrated ownership has a negative effect on company performance (Yurtoglu, 2000).

For this reason, the Indonesia Stock Exchange (IDX), as the authority that regulates and supervises public companies registered in the Indonesian capital market, issued regulation No. Kep-00001 / BEI / 01-2014, which required that public companies comply with the provisions for the ownership of public shares (free float) of at least 7.5% of the total paid-up shares. The minimum free float set is expected to improve company performance, issuer's stock price and investor confidence in the issuer. Furthermore, the IDX confirmed that companies that cannot meet the threshold of the free float are threatened to be subject to sanctions (InvestorDaily, 2019). The enforcement of the IDX regulation is an effort to increase liquidity and stock prices in the capital market, as well as to protect weak investors, as minority shareholders. According to Farnia (2015) and Cueto (2009), one of the basic parameters

for evaluating capital markets is the amount of free float of shares, which is an indication of the level of liquidity, risk and company value and the level of protection for investors.

2. Literature review and hypothesis

Research on the structure of ownership and company performance has been carried out in the literature focused on company performance, and it is generally related to stock liquidity (Rezaei and Tahernia, 2013), liquidity risk (Afkhami, Hashemi, and Hashemi, 2012), accounting profit and ratios based on company financial statements (Bostanci and Kilic, 2010; Ozer and Yamak, 2001; Zraiq, 2018). Although there are studies addressing the influence of ownership structure on company performance, the existing results are mixed. Moreover, there are many studies observing the influence of audit quality on company performance (Farouk and Hassan, 2014; Johnson, Khurana, and Reynolds, 2002; Matoke and Omwenga, 2016; Moutinho, Cerquera, and Brandao, 2012; Sayyar, Basiruddin, Elhabib, and Abdul Rasid, 2015), which also produce contrasting results. This research focused on exploring the impact of free float shares and audit quality on the company performance in Indonesia, an emerging stock market country.

2.1. Free float share and company performance

Public share ownership represents the number of shares held by the public, expressed in shares or percentage owned by the public through the capital market. Salmon (1989) defines free float as the share of the total capital of a company that is available for trading in stocks without limitation. The higher the public ownership of the company shares, the more professional, accountable and transparent a company is required to be, as it is overseen by more stakeholders, which ultimately reduces investment risk, and increases demand (Afkhami et al., 2012; Ding and Zhong, 2016; Rezaei and Tahernia, 2013; Venkatesh, 2000) and company value.

Free float equity is the number of minority shares with ownership under 5% outstanding and available for transaction in the capital market. The higher the free

float in the issuer's company, the more it can be considered that the share price movement is a reflection of market activity. Furthermore, Bostanci and Kilic (2010) state that the size of the portion of free float shares is an indicator of the extent of legal protection for the weak share ownership. Consequently, as stated by Nokambe and Garkaz (2015), there is a significant relationship between ownership variables and stock prices which has implications for the value of the company and performance.

Bostanci and Kilic (2010) examined the relationship between the free float ratio and market performance of stocks in Turkey. The data contained 199 companies listed on the Istanbul Stock Exchange (ISE) for the year 2007. The results of the empirical study show that trading activity is significantly higher for a stock with a higher free float ratio.

Within the same research setting (ISE), the study conducted by Ozer and Yamak (2001) indicated that ownership characteristics significantly influence company performance (return on assets: ROA, return on equity: ROE, and total assets turnover: TATO), the identity of the controlling shareholder playing a major role. Whereas the research conducted by Yurtoglu (2000) on the same market (i.e. Istanbul Stock Exchange, characterized by concentrated ownership with predominantly family owned companies) proves that concentrated ownership has a negative effect on company performance (ROA, market to book value: MBV, and Dividend payments). Ozer and Yamak (2001) also showed that ownership characteristics only have a significant effect on some dimensions of company performance (e.g. ROA, ROE, and TATO). In general, the performance of stocks in the capital market is influenced by the performance of the company (Sailendra and Suratno, 2014).

Research conducted by Fang et al. (2013) regarding stock liquidity and pricing of earnings within the context of stock reforms aimed at converting non-floating shares to floating in China, obtained empirical evidence that prices of non-floating shares incorporate less earnings information, compared to floating ones, the difference being maintained after the reform, as regards restricted versus free floating shares. The transformation from non-floating shares to floating shares can increase the motivation of managers to improve company value and company performance. The conflict of interests between non-tradable shareholders and tradable shareholders is

a severe agency problem (Huang and Fung, 2005), which subsides after the transfers from non-floating to floating shares (Tseng, 2012). Consequently, the Chinese regulator requires that the transfer price from non-floating to floating shares to be based on the company's fundamentals; i.e. net book value per share (BVPS), ROE, return on investment (ROI), recent market price and reasonable price-to-earnings ratio (PER) (Fang et al., 2013).

The study conducted by Rezaei and Tahernia (2013) examined the relationship between free floats of shares and the liquidity of stocks for public companies in the Teheran Stock Exchange (TSE). The sample consisted of 63 companies listed on the TSE market for the period 2005-2009. The empirical results show that there is a positive relationship between the free float of shares and the liquidity of stocks. This study concludes that a higher percentage of free float shares will increase the liquidity of the stock, which can enhance the company performance through better funding.

Ding et al., (2016) conducted a study on the relationship between free float and stock market liquidity using a sample of 55 countries from 2003-2011. The research results prove that the higher the percentages of the free float, the higher the level of liquidity of the stock. Overall, the results of this study indicate that liquidity can be increased by a free float that can affect stock returns and company performance. A high free float converts into low liquidity risk, which can increase transaction volume and expected returns on investments (Afkhani et al., 2012).

2.2. Audit quality and company performance

Audit quality is the probability for an auditor to find and report violations in the client's accounting system, as a level of certainty or guarantee for users of financial statements that financial audit was carried out professionally and independently (Deangelo, 1981). Moreover, other definitions for audit quality, according to Ardelean (2015), take into account the audit's ability to improve financial reporting, a low probability for unqualified audit opinions given on financial statements containing inadvertencies, as well as the accuracy of information reported by auditors. The auditors are a representation of the public trust in the profession, as they are professionally engaged in the public interest.

Duska and Duska (2003) state that trust is a quality inherent in the profession and services provided by the

auditor, and, consequently, financial statements lose their value if the auditor has lost the public trust. Accordingly, improving the quality, integrity, and reliability of financial statements is linked with the increase in the quality, credibility, and effectiveness of auditor functions (Ezzell, 2002). The results of the research conducted by Slaheddine (2015) show that investors better appreciate financial reports audited by a Big *n* company, which allow for an increased predictability of earnings, and therefore for a better assessment of company's value and future prospects. Moreover, financial statements submitted by a company were found to be more trustworthy if the company benefited from high quality auditing services (Gul, Kim and Qiu, 2010), as audit quality has an effect on firm value (Houmes, Forley and Cebula, 2013), increasing the company performance reporting quality. Within the same lines, Kothari (2001) shows that shareholders still pay attention to audited financial statements because they contain reliable information to assess company performance.

According to previous studies, there are different proxies used for audit quality: e.g. audit fees (Bala et al., 2018; Moutinho et al., 2012; Sayyar et al., 2015), audit tenure (Azizkhani et al., 2018; Sayyar et al., 2015), industry specialist auditor (Clinch et al., 2012; Mukhlisin, 2018) and auditor size (Deangelo, 1981; Farouk and Hassan, 2014; Hua et al., 2016). Audit fees are chosen as a proxy for audit quality as large fees can suggest the effort to improve audit quality, although the reverse is also possible, as they can reflect monopoly circumstances and client dependency.

The results of the research conducted by Moutinho et al. (2012) on audit fees and firm performance on a sample of public companies in the United States of America from 2000-2008, obtained empirical evidence that audit quality has a negative effect on firm performance in line with the research results obtained by Johnson et al. (2002). However, research conducted by Sayyar et al. (2015) on audit quality (audit fees and auditor rotation) in Malaysian public companies, from 2002-2012, found evidence that audit quality has a significant positive impact on company performance, but only when measured by Tobin-Q, and not by ROA.

Azizkhani et al. (2018) examined the association between audit tenure and audit quality of financial reporting. The sample consisted of 343 companies from traded Iranian companies that were audited by private-

sector auditors operating on the Iranian audit market for 2010. The results show that audit tenure (frequent rotations) appear to improve company performance.

Robu, Grosu and Istrate (2016) examine the effect of the auditors' rotation on the accounting quality in the case of Romanian listed companies transitioning to IFRS. The study was carried out on 64 Romanian companies listed on the Bucharest Stock Exchange, for the period between 2006 and 2014. The research results show that audit tenure (auditor rotation) significantly contributes to the change in value relevance of company performance.

According to Mukhlisin (2018), audit industry specialization shows audit competencies in specific industries, so that industry specialized auditors have more ability to detect material misstatements as a result of fraudulent financial reporting, which is an indicator that audit quality can increase company performance. These results are in-line with the research conducted by Clinch et al. (2012) in the context-US public companies, which proxied audit quality through the appointment big *n* audit firms and industry specialized auditor, and employed a sample of 4062 years-observation from 2002 to 2005. This study concluded that audit quality is playing a role in the quality of financial reporting and, through the allocation of information among traders, can increase company performance.

Hua et al. (2016) examine the association between audit quality (using auditor size as a proxy for audit quality) and corporate performance (ROA, ROE and ROI). Data was collected from the public companies listed on the Malaysian stock exchange for the period 2010-2013, the results indicating that audit quality has a significantly positive impact on company performance.

Sulong et al. (2013) examined the impact of managerial ownership, leverage and audit quality on firm performance for companies traded on the Malaysian Access, Certainty, and Efficiency (ACE) market. The sample consisted of 82 companies listed on the ACE market for the period 2007 to 2009, the results showing that audit quality has a statistically significant negative impact on firm performance.

However, research conducted by Martinez and Moraes (2014) on the relationship between audit quality and company performance, for Brazilian public companies from 2009-2010, obtained empirical evidence showing that audit quality has a significant positive effect on company performance, in line with the findings reported

by Ani and Mohammed (2015), Chen et al., (2011), Farouk and Hassan (2014), and Matoke and Omwenga (2016).

3. Data collection, sample size, and research method

3.1. Data collection and sample size

This study uses a quantitative method based on a sample of manufacturing public companies listed on the Indonesia Stock Exchange from 2013-2015,

totaling 80 companies or as many as 320 years-observation. The companies' financial data comes from the Thomson Reuters Eikon database, while the audit quality data comes from the Centre of finance and profession development, the Ministry of Finance of the Republic of Indonesia. Public share ownership data originates from the database of the Indonesia stock exchange (BEI).

Research variables, both dependent, independent and control variables, are measured from each "i" company sampled, in the year "t", during the observation period (Table no. 1).

Table no. 1. Summary of variables measurement

No.	Variables	Operationalisation
Dependent variables		
1	MBV	Market capitalization divided by net book value
2	ROA	Earnings before tax divided by total assets
3	ROE	Net income after tax divided by total equity
4	ROCE	Earnings before tax and interest cost divided by total assets minus current liabilities
5	TATO	Net sales divided by total assets
6	Tobin-Q	Market capitalization plus total debt divided by total assets
Independent variables		
7	Free float share	The total nominal of traded stocks divided by total nominal of shares
Audit Quality		
8	Audit fee	Natural logarithm of audit fees per year paid by the company to the auditor
9	Audit Tenure	The total length of auditor's tenure with the company
10	Auditor Ind. Specialist	Percentage of total auditor market share by industry
11	Auditor size	Total number of auditor's clients
Control Variables		
12	Company Age	Total number of years since the company was established
13	Company Size	Natural logarithm of total asset at the end of the year

Source: Own projection

3.2. Methodology

The hypothesis and relationships between variables of this study were tested using the Structural Equation Modeling-Partial Least Square under the Smart-PLS statistical program, version 3.0, based on the following research model:

$$CP = \beta_0 + \beta_1 FF + \beta_2 AQ + \beta_3 CA + \beta_4 CS + \varepsilon$$

Notes:

CP = Company performance; FF = Free float; AQ = Audit quality; CA = Company age; CS = Company size; ε = Error

4. Statistical summary, analysis and results

4.1. Descriptive Statistics

We display descriptive statistics in Table no. 2.

Table no. 2. Descriptive Statistics

Variable	N	Min.	Max.	Median	Mean	SD
Dependent Variables						
MBV	320	-14.78	165.30	1.05	4.50	14.40
ROA	320	-0.21	0.66	0.03	0.05	0.09
ROE	320	-7.48	1.76	0.07	0.06	0.54
ROCE	320	-0.39	1.68	0.06	0.11	0.24
TATO	320	-0.06	1.28	0.14	0.20	0.22
Tobin-Q	320	-0.59	120.86	0.51	2.07	9.04
Independent Variables						
Free float share	320	0.23	66.78	22.76	25.78	15.24
Audit fee	320	7.81	10.60	8.84	8.86	0.52
Audit tenure	320	1.00	7.00	3.00	2.93	1.62
Audit Ind. Specialist	320	1.00	2.00	1.00	1.33	0.47
Auditor size	320	1.26	3.34	2.96	2.93	0.32
Control Variables						
Company size	320	10.99	14.42	12.34	12.42	0.70
Company age	320	4.00	87.00	36.00	36.44	13.49

Source: Authors' processing, following the Smart-PLS 3.0 output.

4.2. Analysis and results

The results of the analysis and the statistical testing of

the relationships between variables are described in
Table no. 3.

Table no. 3. Statistical Results

	Original Sample (O)	Sample Mean (M)	Standard Deviation	T Statistic (O/STDE)	P Values
AQ→CP	0.318	0.328	0.048	6.618	0.000***
FF→CP	-0.028	-0.024	0.042	0.663	0.254
CS→CP	-0.267	-0.275	0.056	4.793	0.000***
CA→CP	0.481	0.481	0.067	7.233	0.000***

The symbols ***, ** and * denote significance level at the 1%, 5% and 10%, respectively.

Source: Authors' processing, following the Smart-PLS 3.0 output.

As presented in **Table no. 3**, results show that Audit Quality (AQ), as defined by audit fees, audit tenure, auditor industry specialization and auditor size, has a significant, positive impact on company performance (CP), as defined by MBV, ROA, ROE, ROCE, TATO and Tobin-Q, indicated by the p-value 0.000. Overall, the results indicate that audit quality plays an essential role in the success of a company measured in terms of performance. The optimal quality of auditing services provided by an auditor can provide additional value to the auditee and improve its performance (Azizkhani et al., 2018; Clinch et al., 2012; Hua et al., 2016; Martinez and Moraes, 2014; Mukhlisin, 2018; Robu et al., 2016).

However, free float of share (FF) has no significant impact on company performance (CP), as shown by the statistical p-value 0.254 (**Table no. 3**). This result could be explained by the fact that, in a country with an emerging stock market, such as Indonesia, the ownership of shares is still concentrated within a group of companies or a private conglomerate. Moreover, many companies still have a low percentage of free float share indicated by the minimum free float value 0.23 (**Table no. 3**), which could explain why the free float of share does not significantly influence company performance.

Among the control variables, company size (CS) is negatively correlated with company performance (CP); which indicates that bigger companies, with higher concentrated ownership structure and less free float share percentage, will perform less compared to the rest of the companies. Company age (CA), however, exhibits a significant positive association with company performance (CP); which suggests that the older the company is, the more experience it has in order to survive and compete on the market, with a bigger free float of share percentage owned by the public. Moreover, the positive impact of company age on company performance could be explained by the longer experience the firm has in dealing with auditors, managing capital markets and stakeholders.

5. Conclusion

This study empirically examines the effect of free float of shares and audit quality (audit fees, audit tenure, auditor industry specialist and auditor size) on company performance (MBV, ROA, ROE, ROCE, TATO and Tobin-Q), for 80 public manufacturing companies listed, from 2013 to 2016, on the Indonesian Stock Exchange (IDX), an emerging stock market with concentrated share ownership characteristics.

The results of our analysis provide empirical evidence that free float shares have no influence on company performance, which can be explained by the

concentration of capital ownership in public Indonesian companies operating in the manufacturing sector during the chosen time frame. The results of this study are in line with the research conducted by Ding and Zhong (2016), who observed no significant correlation between free float of shares and share liquidity, especially for countries such as Indonesia, with emerging stock markets, due to concentrated share ownership and small percentage of free float, which has usually a negative effect on company performance (Yurtoglu, 2000). For this reason, the implications of these results for regulators are to encourage public companies to increase free float shares, so that ownership is not concentrated in a single group, which could improve company performance. Our results also show that audit quality has a significant positive effect on company performance.

The results of this study cannot be, however generalized to all types of industries, for which future research is needed that could also include others proxies for company performance, such as corporate governance, marketing aspects or social and environmental responsibility. Based on previous research, the results of this study contribute to the literature and could constitute a reference for future research on the impact of free float share and audit quality on company performance, especially in the emerging stock markets, such as Indonesia.

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