The Influence of Corporate Governance Structure towards Underpricing

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Abstract. This study aims to analyze the influence of corporate governance structure on underpricing when firms perform an Initial Public Offering (IPO). This study is based on the signaling theory, stating that the existence of proper corporate governance structure at the time the firm conducting IPO will give the firm a high quality signal to potential investors. The corporate governance structure tested includes the size of Board of Commissioners (BOC), the level of independence of the Board of Commissioners, and the existence of an audit committee. The hypothesis testing is done using a multiple regression model with a sample of 95 observations from firms doing IPOs listed on the Indonesia Stock Exchange during the period of 2005-2012. The results of this study provide empirical evidence that: (1) the size of Board of Commissioners is negatively correlated and affects underpricing, (2) the level of independence of the Board of Commissioners has no effect on underpricing, (3) the existence of an audit committee has no effect on underpricing, (4) corporate governance structure (the BOC size, the independence of the Board of Commissioners, and the existence of audit committees) simultaneously has a positive and significant correlation to underpricing.

Keywords: audit committee, board of commissioners, board independence, corporate governance, underpricing

INTRODUCTION

Initial Public Offering (IPO) is an activity of a firm to seek additional funds for development or for business expansion of the firm (Caselli, 2010). At the time of initial public offering (IPO), the firm has private information about the firm’s future prospects, while potential investors have little information about it. Firms need to use a suitable mechanism to overcome the information asymmetry. According to Akerlof (1970), investors will evaluate all firms doing an IPO based on the average value. As a result of this assessment, the firm with a higher value than the average will withdraw from the market, and the average remaining firms, deciding to keep seeking funding (IPO), will fall. This process will continue until the firm with the lowest value is left in the market. To overcome this, the signaling perspective states that firms with a higher value (than the average value) are motivated to find a mechanism to communicate the private information of the firm that can be trusted to potential investors.

The basis of signaling theory is a good firm can provide a signal of the firm’s condition by conducting an underpricing IPO determination. The underpricing phenomenon in IPO occurs when the secondary price during IPO is significantly lower than during traded in the secondary market. As proposed by Kusumawati and Sudento (2005), this phenomenon also occurs in almost every country in the world. In Indonesia alone, the level of underpricing found relatively lower compared to some developed countries, as has been found by Prastiwi and Kusuma (2001), Emnyan and Husnan (2002), and Ali and Jogiyanoto (2003).

According to Leland and Pyle (1977), a rational investor would account for the ownership part of the former owner of the shares; it becomes a valuable signal that can reflect the value of the firm. The decrease in the proportion of shareholding of the old owners indicated by the supply of new shares to outside investors is a negative signal. Conversely, the higher the percentage of shares retained by the previous owner is a positive signal for the market.
Jogiyanto (2000) adds that the information published as an announcement will give a signal to investors in making investment decisions. If the announcement contains a positive value, it is expected that the market will react at the time the announcement is received by the market. Another characteristic is that the given signal must be expensive and difficult to be replicated by other firms doing a low quality IPO. Firms performing IPO set an underpriced stock to give a signal that their firms are high-quality (Yatim, 2011).

Existing studies widely use signaling theory to show this dilemma of information asymmetry (Akerlof, 1970). Signaling theory states that some indicators provide signals to potential investors about the firm’s ability to do IPO as well as the possibility of the future value of the firm. Previous research reports stated that a reliable communication explaining important information at the time the firm conducts an IPO can reduce information asymmetry between IPO issuer and investors. The basic idea of this study is when a firm conduct initial public offering, where there is no alternative sources of information, the IPO assessment by investors will depend on the net assets and income of the firm, as well as the cash flow from the asset. The firm’s prospectus, issued by the company at the time of IPO, contains information about the assets, sources of income, the economic outlook, and investment planning. In order to add to the credibility of the main parameters assessment, the firm will create a strategy and show the data that gives a signal on the private information of the firm to potential investors.

Furthermore, Rock in Susanto (2007) also states that the information asymmetry can occur between groups of informed and uninformed investors. The investors with better information will buy the IPO shares if it will later generate a return; while investors with information only from the prospectus of issuer firms will buy stocks at random, both overpriced and underpriced shares. As a result, the uninformed group would obtain a greater proportion of ownership on the overpriced shares and leave the primary market since they suffer significant losses. Information asymmetry is when managers have better information on the condition or prospects of the firm than investors (Brigham and Houston, 2001). According to Bodie et al. (2009) information asymmetry allows an investor to have a private information on the value of a security unknown by other parties. Through information asymmetry, investors can get returns by buying shares when underpriced and sell them when overpriced. If private information indicates an overpriced stock, investors will decide to sell it. An occurring information asymmetry can lead to agency problem (Susanto, 2007).

According to agency theory, the shareholders (principals) hire agent (manager) to manage the firm’s resources effectively and efficiently to generate profit and maintain the sustainability of the firm. Conflicts of interest often occur between the principal and agent, commonly called the agency problem; where the agent is not acting in accordance with the interests of the principal so that it will affect the performance of the firm. The existence of agency problems may hinder the achievement of firm goals, i.e. to increase the value of the firm. To overcome these problems, we need a mechanism called corporate governance (Jensen and Meckling, 1976). Tjager et al. (2003) state that the term corporate governance was first introduced by the Cadbury Committee in 1992 in a report known as the Cadbury Report. In its development, there are various definitions of corporate governance, both based on the sharing theory and stakeholder theory.

Sulistianto (2003) gives a positive indication of the influence of good corporate governance implementation on the public trust. This is because the firm managed more professionally can improve the welfare of its owners or shareholders without ignoring the interests of its stakeholders so that it will improve the positive expectations of society on the firm implementing good corporate governance. The role of corporate governance in addressing agency problems is through monitoring both internally and externally (Jensen and Meckling, 1976; Saragih, 2012). In this case, corporate governance is a set of rules governing the relationship between shareholders, management (managers) of the company, creditors, government, employees and other internal and external stakeholders, relating to their rights and obligations, or in other words a system that regulates and controls the firm.

According to Barnhart and Rosenstein (1998), corporate governance mechanism includes internal mechanisms, such as the structure of the Board of Directors (BOD), managerial ownership and executive compensation, and external mechanisms, such as the market for corporate control, institutional ownership and the level of debt financing. Corporate governance provide effective protection for shareholders and creditors so that they believe they will earn a return on their investment. Corporate governance also help create a conducive environment for an efficient and sustainable growth of the corporate sector (FCGI, 2003 in Nasution and Setiawan, 2007). The discussion on this research focuses on the influence of corporate governance structure on underpricing. The role of corporate governance structure is measured by the board size, board independence and audit committee.

In the current era of globalization, corporate governance is one of the important determinants for the growth, development and success of a firm. The global economic crisis, not to mention in Asia countries a few years ago, is one of the results of the weak implementation of good corporate governance. Sarra (2003) revealed that the governance of the firm management is a structure made by the firm to increase capital with low costs, to leverage assets efficiently, and to have reliable employees so as to reduce the agency cost. There are two things that must be considered in the concept of corporate governance: First, the importance of the shareholders to acquire their rights to obtain information that is correct and timely. Second, the obligations of the firm for an accurate, timely, and transparent disclosure to all information the firm’s performance, ownership, and stakeholders (Kaihatu, 2006). The signal of corporate governance structure can be explained from the size of the Board of Commissioners, the level of independence of the Board of Commissioners, and the existence of an audit committee (MNF, 2009).

The Board of Directors (in Indonesia is better known as the Board of Commissioners) is one of the firm organs in charge to supervise and provide advice to the directors.
as well as ensure that the company has implemented corporate governance well. The Board of Commissioners is the core of corporate governance, assigned to ensure the implementation of corporate strategy, oversee the management, as well as require the implementation of accountability (Zehnder, 2000). Bermalin and Weisbach (2003) find evidence that the board with a smaller number of members would be more effective than the board with a greater size. The influence of board size on the firm performance is proposed by Fama and Jensen (1993) stating that the small board size is the result of technological and organizational changes that can reduce costs and firm downsizing. Xie et al. (2001) suggested that a small board size will be less burdened by bureaucratic problems thus can be more functional.

The effectiveness of the board to limit the occurrence of earnings management in financial reporting depends on the independence of its members. Beasley (1996) in his study provides evidence that the presence of independent directors will reduce the level of fraud in financial reporting. A member of the board cannot be considered independent if he has been working on the firm over 5 years (Kim et al., 2010). Chtouru et al. (2001) have three characteristics about the board independence, i.e. the presence of independent directors on a board, the separation between the chairman of the board with the CEO, and the existence of an independent national committee. Furthermore, Fama and Jensen (1983) stressed the importance of outside board members in exercising the function of controlling board decisions. The independence from managerial influence makes the outside directors in a better position to protect the interests of shareholders from opportunistic actions of the management. External directors can better perform their task to monitor the firm effectively since it has a smaller probability to collude with the managers to influence the welfare of the shareholders (Dhaliwal, 2007). A similar statement is expressed by Kim et al. (2010) stating that shareholders and regulators believe that the independent directors will be more effective in evaluating management performance. Academic research also supports this statement with the conclusion that when a firm’s performance declines, only the independent directors dare to dismiss the CEO accessed to be ineffective in running the firm.

Meanwhile, the audit committee has the authority to access records or information concerning employees, funds, assets and other resources of the firm associated with the performance of its duties. The audit committee has an important role in the corporate governance structure, in terms of preparation of quality financial statements. Good audit committee must have certain characteristics in order to create a better corporate governance; Dhaliwal et al. (2007) suggests three characteristics, i.e. the audit committee has a minimum of three members; there is an independent board member in the audit committee; it meets at least four times a year. Hrichi (2009) focused his research on three characteristics considered important in improving corporate governance, namely the independence of the audit committee, the expertise of the audit committee members, and the meeting frequency of the audit committee members.

Accordingly, do the size of Commissioners Board, its level of independence, as well as the existence of an audit committee influence the underpricing at the time of IPO? The aim of this research is to analyze the influence of the board size, its level of independence, and the existence of an audit committee on underpricing, as well as analyze the influence of the corporate governance structure.

**RESEARCH METHODS**

This study uses a quantitative approach and the aim of the research is explanatory. The data used are cross-sectional data. The samples are firms performing initial public offering (IPO) during the period of 2005-2012. The selection of research period starting in 2005 is founded upon Bappepam-LK decision (now the Financial Services Authority/OJK) who implemented strategies to improve corporate governance in Indonesia by making the Indonesian Capital Market Master Plan 2005-2009. The data used are the quantitative data from the firms’ prospectus. The data are analyzed regressively with reference to the stages of classical assumption testing

\[
IR = \frac{P_{t1} - P_{t0}}{P_{t0}} \times 100\% \quad \text{..................}(1)
\]

Description:

- \(IR\) : Initial return
- \(P_{t0}\) : IPO price
- \(Pt1\) : closing price on the first day of secondary market

In this study, the independent variables include the size of the Board of Commissioners (BSIZE), the percentage of independent board of commissioners in the board structure (INDEAD), and the existence of an audit committee at the time of IPO (AC). The three variables are part of the corporate governance structure. Another independent variable is the variable of the firm’s life span from its initial establishment to the IPO (AGE), firm size (FSIZE), and the firm’s debt ratio or leverage (LEV) as the controlling variable. While the dependent variable in this study is the level of underpricing (UNDPRIC), measured by the initial return, i.e. the difference between the closing price on the secondary market divided by the offering price multiplied by 100% (Suyatmin and Sujadi, 2006). The model used in this study refers to Anis (2009).

\[
\text{UNDPRIC} = \beta_0 + \beta_1\text{BSIZE} + \beta_2\text{INDEAD} + \beta_3\text{AC} + \beta_4\text{AGE} + \beta_5\text{FSIZE} + \beta_6\text{LEV} + \epsilon \quad \text{............}(2)
\]

Description:

- \(\text{UNDPRIC}\) : underpricing level measured by \((P1-P0)/P1\); where \(P1\) is the closing price on the first day of IPO, while \(P0\) is offering price.
- \(\text{BSIZE}\) : the board size
- \(\text{INDEAD}\) : the number of independent commissioners in the board
RESULT AND DISCUSSION

The samples used in this study are firms doing IPO in Indonesia Stock Exchange in 2005-2012 period. Based on the existing data, the number of firms that became samples are 95 firms.

Table 2 explains the descriptive statistics from the dependent variable of underpricing from the firm samples doing IPO in the period of 2005-2012.

Based on Table 2, the average variable value of underpricing (UP) is equal to 0.210595. This shows that the average underpricing in this study is 21.06%, in other words the average stock price of the firms taken as samples at the time of IPO increased by 21.06% from the closing price on the first day of IPO. The table also indicates that the level of underpricing occurred in the sample firms is between 1.29% to 44.19%. This result indicates that the underpricing level of research samples is lower compared to the research conducted by Salim and Randy (2012) conducted in Indonesia from 2003 to 2011 with a maximum value of underpricing (initial return) of 70%. The average value of board size (FSIZE) is 3.78 or e^3.787234.

Table 1. Sample Selection

<table>
<thead>
<tr>
<th>Stage</th>
<th>Description</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Firms doing IPO in Indonesia Stock Exchange in the period of 2005-2012</td>
<td>146</td>
</tr>
<tr>
<td>2</td>
<td>Firms without underpricing</td>
<td>(35)</td>
</tr>
<tr>
<td>3</td>
<td>Firms in financial sector</td>
<td>(16)</td>
</tr>
<tr>
<td>4</td>
<td>Research samples</td>
<td>95</td>
</tr>
</tbody>
</table>

Table 2. Descriptive Statistics

<table>
<thead>
<tr>
<th>Variable</th>
<th>Mean</th>
<th>Median</th>
<th>Modus</th>
<th>Max.</th>
<th>Min.</th>
<th>Std. Dev.</th>
</tr>
</thead>
<tbody>
<tr>
<td>UP</td>
<td>0.210595</td>
<td>0.191964</td>
<td>0.41764</td>
<td>0.441860</td>
<td>0.012987</td>
<td>0.133838</td>
</tr>
<tr>
<td>BSIZE</td>
<td>3.787234</td>
<td>3.000000</td>
<td>3.000000</td>
<td>10.000000</td>
<td>2.000000</td>
<td>1.605584</td>
</tr>
<tr>
<td>INDEAD</td>
<td>0.383143</td>
<td>1.000000</td>
<td>0.333333</td>
<td>0.666667</td>
<td>0.000000</td>
<td>0.104705</td>
</tr>
<tr>
<td>AC</td>
<td>0.351064</td>
<td>0.000000</td>
<td>0.000000</td>
<td>1.000000</td>
<td>0.000000</td>
<td>0.470862</td>
</tr>
<tr>
<td>FSIZE</td>
<td>3.14612</td>
<td>7.47E+11</td>
<td>-</td>
<td>7.09E+13</td>
<td>2.32E+10</td>
<td>1.20E+13</td>
</tr>
<tr>
<td>LEV</td>
<td>0.608368</td>
<td>0.618100</td>
<td>0.569400</td>
<td>1.839500</td>
<td>0.000000</td>
<td>0.242699</td>
</tr>
</tbody>
</table>

Anis (2009) shows that the board size has a significant positive effect on the level of underpricing. Meanwhile, Salim Darmadi and Randy Gunawan (2012) explain that the board size variable has a significant negative relationship with underpricing, indirectly a larger board is expected to reduce information asymmetry between the firm conducting IPO and potential new investors. Then Mak et al. (2003) describes that the influence of corporate governance on stock price at the time of IPO indicates that the board size has a negative correlation to the premium stock price and premium market price. Thus, H1 is the board size has a negative effect on underpricing. Furthermore, the independence level of the board of commissioners (board independence) has a significant negative effect on the magnitude of underpricing (Anis, 2009), also in line with Salim Darmadi and Randy Gunawan (2012) affirming that significantly the board independence is negatively correlated to the level of underpricing. Furthermore, the audit committee is a component of the corporate governance structure to create a signal to investors on the quality of a firm and the information contained in the prospectus. In line with H1, H2 is the board independence have a negative effect on underpricing. Finally, referring to Bedard et al. (2008) the presence of the audit committee significantly affects the decrease in underpricing level during the firm’s IPO. Thus, H3 is the audit committee has a significant negative effect on underpricing.

Referring to conducted sample selection, this study uses 95 firms as sample criteria. After the model statistical test consisting of partial significance test (Test T), simultaneous significance test (Test F), and the model relevance test or the coefficient of determination (R2), the result of data processing can be seen in Table 3. Based on Table 3 it can be seen that the value of R2 is 0.170. This means that the underpricing variable can be explained by the variations of independent variable, namely the board size, the independence of the board of commissioners, audit committee, firm life span, firm size, and the leverage of 17% while the remaining 83% is explained by other factors not included in the study. Furthermore, the value of Adjusted R2 in this study shows an indication of the need for additional independent variables, shown by the smaller value of Adjusted R2 than the value of R2. Moreover, the t statistic test is used to show how significant is the
influence of an individual or partial independent variables on explaining the effect of the dependent variables. At the t-test, the significant level is in 1%, and 5% depending on probability value at t-stat.

Based on the regression results in Table 3 it can be seen that the t-stat value for variable of BSIZE is -3,043 with probability value of 0.003, meaning that BSIZE variable has a negative coefficient on underpricing and has a significant influence on α = 1%. It can be concluded that the results of this study support the research hypothesis of H1, meaning that the board size has a negative effect on underpricing, so that the greater the number of commissioners, the smaller the level of underpricing will be. This means the board size may help reduce the information asymmetry in the eyes of investors. The negative correlation shown between the board size and underpricing indicates that the greater the board size, each person in the commissioners will contribute differently due to different backgrounds; thus in this case the benefits received by the board of commissioners will be greater. In addition, the large size of the board can be more effective in increasing the role of corporate governance structure in the firm; it can reduce the information asymmetry occurring between the firm and investors, so that the level of underpricing will be smaller. This is in line with the proposition of Xie et al. (2001) related to profit management stating that the large board size tends to have independent directors more experienced in the field of finance. Thus, a greater board size can be better in preventing the occurrence of profit management by the firm. Similarly research by Anis (2009) and Hearn (2011) also show the board size has a significant coefficient of negative effect on the of underpricing. Xie et al. (2001) also found that board size has a significant negative influence on underpricing. These results indicate that the number of board members can help reduce the level of corporate information asymmetry. The board size can be used as a tool to measure the ability of coordination and communication of the board. An empirical research conducted previously by Mak et al. (2003) also gives the result that the board size as part of the corporate governance structure has a negative correlation to the premium stock offering price and the premium market price, meaning that the greater the board size, stock price at the time of the IPO tends to be low, hence the higher the level of underpricing.

INDEAD variable shows the t-stat value of -1.322 with a probability value of 0.189, meaning that INDEAD variable has a negative correlation and no significant effect. Thus the result does not support the research hypothesis of H2, meaning that the independence of the Board of Commissioners has no effect on the underpricing of firms doing IPO. This indicates that the independence level of the commissioners board, functioning to control of the board of commissioners’ decision, is not capable to control opportunistic actions of corporate management. The independence of commissioners board cannot explain the firm’s ability to reduce the level of fraud in financial reporting. In the descriptive analysis, it can be seen that the minimum value of INDEAD variable explaining the board independence is 0, while the maximum value is 66.7%. It means that there are still firms without independent Board of Commissioners during the IPO. This result is also confirmed by Yatim (2011) who conducted a research on the Malaysian Stock Market from 1999 to 2008. The study did not find any influence of the board independence on underpricing. This may indicate that investors believe that the firms newly doing IPO will run better if led by the old board of commissioners old who really understand the condition and growth of the firm very well, compared to entrusting it to the board independence (Yatim, 2011).

This result is contrary to the research conducted by Anis (2009), finding that independent directors have a significant negative effect on underpricing. The board independence of a firm gives a signal that the firm has implemented the corporate governance system well. Accordingly, potential investors will increasingly believe the credibility of the financial statements contained in the prospectus so as to reduce investors’ sense of distrust and ultimately reduce the underpricing.

Furthermore, in Table 3 we can also see that the t-stat value for AC variable is 0.813 with the probability value of 0.419, meaning that the variable AC has a positive correlation and does not have a significant effect on the α = 5%. These results do not support the research hypothesis of H3, meaning that the existence of an audit committee does not have an influence on the underpricing of firms doing an IPO. The result is in line with Anis (2009), finding that the audit committee in firms doing an IPO does not significantly influence underpricing. The audit committee cannot be used as a signal that the firm has run its monitoring function well, where such is very useful for the firms to convince investors to purchase their stock offering. This may be caused by the many firms in Indonesia that are still less aware of the importance of good corporate governance in a firm. The still worse implementation of corporate governance system is seen in the entire research samples: 60.36% firms do not have an audit committee when performing IPO in 2005-2012. The analysis result is contrary to the research conducted by Bedard et al. (2008), finding that an audit committee can be used as a signaling strategy for the firm with independent audit-committee members and their competence in the field of finance. This can have a significant effect on reducing the underpricing during the IPO.

<table>
<thead>
<tr>
<th>Variable</th>
<th>Coefficient</th>
<th>Std. Error</th>
<th>t-Stat</th>
<th>Prob.</th>
</tr>
</thead>
<tbody>
<tr>
<td>BSIZE</td>
<td>-0.02627</td>
<td>0.00863</td>
<td>-3.04327</td>
<td>0.0031**</td>
</tr>
<tr>
<td>INDEAD</td>
<td>-0.18081</td>
<td>0.13674</td>
<td>-1.32229</td>
<td>0.1895</td>
</tr>
<tr>
<td>AC</td>
<td>0.023339</td>
<td>0.028718</td>
<td>0.812718</td>
<td>0.4186</td>
</tr>
<tr>
<td>AGE</td>
<td>0.000282</td>
<td>0.000942</td>
<td>0.298922</td>
<td>0.7657</td>
</tr>
<tr>
<td>FSIZE</td>
<td>4.37E-16</td>
<td>1.68E-15</td>
<td>0.259966</td>
<td>0.7955</td>
</tr>
<tr>
<td>LEV</td>
<td>-0.12099</td>
<td>0.054419</td>
<td>-2.2233</td>
<td>0.0288*</td>
</tr>
<tr>
<td>C</td>
<td>0.438696</td>
<td>0.069195</td>
<td>6.339984</td>
<td>0</td>
</tr>
</tbody>
</table>

Note: * and ** show significance level at 5% and 1%.
In this study, the concept of corporate governance structure can explain its influence on underpricing. Good corporate governance is proven capable to explain and influence underpricing, as well as capable to the firm’s mechanism to reduce the information asymmetry for potential investors.

CONCLUSION

The results of the research show that the size of Commissioners Board influences the level of underpricing, while the independence level of the board does not have a significant effect on the level of underpricing. Meanwhile, the existence of an audit committee does not have a significant effect on underpricing. As a consequence, the firm can pay more attention to the corporate governance structure as a way to give a signal to investors and potential investors about the firm’s performance. The greater number of commissioners will give effect to the lower level of underpricing. It shows that the board size can help reduce the level of corporate information asymmetry. The number of commissioners can be used as a tool to measure the ability of coordination and communication. Investors and prospective investors can use the results of this study to determine the signal given by the firm regarding its performance.

Of the corporate governance structure described in this study, investors may consider the board size in taking the decision to invest in a firm doing an IPO. It refers to the result that the greater number of commissioners will affect the lower level of underpricing. In addition to investors, the issue underwriters can use these results to determine the reasonable initial public offering price. Furthermore, the regulator as the policy makers regarding the corporate governance implementation in Indonesia is expected to use the results of this study as an input for setting the policy on corporate governance in Indonesia so that its implementation can run well. Financial Services Authority (OJK) may further monitor the number of commissioners in a firm, as well as create regulations on the composition of the Commissioners Board members of a firm doing an IPO in order to ensure the implementation of good corporate governance in Indonesia.

The results of this study can contribute to academia and science concerning the influence of corporate governance structure on the underpricing level of a firm. The good and effective corporate governance implementation can reduce the information asymmetry, hence reducing the level of underpricing. Therefore, this study is expected to add to the literature for academicians regarding the good corporate governance implementation in Indonesia, particularly in terms of its influence on the level of underpricing. This study, nevertheless, has some limitations; it is expected, therefore, that further research may use longer intervals period so it can get a more comprehensive picture on the effect of variables used in a better and consistent manner. Future studies could also use another measurement often used for the level of underpricing, like abnormal return.

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