

**School of Economics and Finance
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**The Effect of Board Composition on Firm Performance in
Indonesia**

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Declaration

This thesis contains no material which has been accepted for the award of any other degree or diploma in any university. To the best of my knowledge and belief this thesis contains no material previously published by any other person except where due acknowledgement has been made.

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Abstract

The study investigates the effect of the compositions of board of directors on firm performance in Indonesia. This country offers a specific institutional environment, which provides a natural setting to further examine the effectiveness of the board in mitigating agency conflicts. The conceptual framework is derived from agency theory, assuming that the governance mechanisms affect the behaviour of contracting parties. The theory predicts that a board's independence determines the effectiveness of its monitoring role and organizational outcome. The study presents a cross-sectional analysis of 190 non-financial companies listed on the Jakarta Stock Exchange during 2002-2004.

Indonesian firms exhibit ownership concentrated in the hands of a few wealthy families and this provides them with sufficient voting rights to influence management and control decisions. Accordingly, the agency problems stem from the conflicts between controlling owners and minority shareholders as such ownership enables controlling owners to commit expropriation. The agency problem is further exacerbated by the presence of family members of controlling owners serving in management and on the boards. This study argues that the involvement in management and on the boards creates the absence of separation between management and control decisions that potentially negates the link between governance mechanisms and firm performance. This dissertation is the first to study the impact of such involvement on the association between board composition and firm performance. This provides sufficient justification that the study offers significant contribution to the governance literature as it applies to Indonesia.

The Jakarta Stock Exchange officially requires that listed firms' boards consist of at least 30% independent directors, or that the number of independent directors be proportional to the shareholding by minority investors, whichever is higher. The results show that most of the domestic-listed firms demonstrate a compliance with such regulation. However, the study fails to document a significant relationship between the fraction of outside directors and firm performance. Further testing reveals that the

proportion of independent directors is insignificantly related to prior firm performance. This indicates that the inclusion of independent directors is irrespective of the agency problem specific to the firm and is merely driven by the listing requirement.

The prevalence of ownership concentration by controlling families has been claimed as providing the rationale to construct a particular framework where the family serves as the unit of analysis. Although Indonesia adopts a two-tier system, such a framework implies that the substance of combined leadership might occur in Indonesia whenever a family member of the controlling owners is assigned as board chairperson. The study shows that most of the Indonesian listed firms have affiliated leadership, where in some instances the family member of controlling owners serves as board chairperson. Using the family as the unit of analysis, this finding provides undeniable evidence that combined leadership exists in the two-tier system. Independent leadership is found to have a positive relationship with firm performance, and such a relationship is robust after controlling for interdependence, measurement, linearity, and endogeneity issues. Governance reform, therefore, should address the board leadership structure that promotes board independence and, accordingly, board monitoring effectiveness.

The analysis reveals that the identity of large shareholders needs to be analyzed separately. Shareholding by controlling owners is found to have a negative association with firm performance. This finding suggests that the presence of dominant large shareholdings in the hands of families is more likely to be the source of the agency problem rather than to serve as a governance device that alleviates agency conflicts. The finding implies that governance reform that seeks to reduce dominant control by the family needs to be addressed. Foreign investors demonstrate a positive relationship with firm performance. Further analysis reveals that ownership by foreign investors is the antecedent of independent board leadership. This finding suggests that this type of large shareholder induces better governance as the leadership board independent is positively related to firm performance. This suggests that Indonesia would be better off whenever a friendly foreign investor regulation is in place.

This study finds that the controlling owners of Indonesian listed firms typically appoint their family members to serve in management and on the boards. The analysis reveals that such appointments create a different impact on the corporate control and firm performance. This study finds that the entrenchment effect of family involvement on the board is higher than that of such involvement in management. This finding suggests the necessity to disaggregate the family control devices. Nevertheless, such involvements provide supportive evidence that controlling owners engage in excessive control enhancing mechanisms that facilitate the extraction of private benefit with relatively ease. Accordingly, this finding implies that Indonesia needs to establish a corporate system that prevents the dominant owners from engaging in excessive control-enhancing mechanisms.

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To Muchlis Hamidy and Nadifa Prabowo Muhammad

.....for the light always lives inside

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Chapter 1: Introduction

1.1. Introduction

One of the primary functions of effective corporate governance is to provide investors with strong protection in exercising their rights (La Porta et al., 2000). Such protection is an important issue in the finance literature, as there is a high possibility that a firm's resources will be expropriated by insiders. Shleifer and Vishny (1997) argue that strong protection will reduce such expropriation and hence, will convince potential shareholders and creditors to finance the firm. Eventually, effective corporate governance will link the firm's resources with the most productive channel (Shleifer & Wolfenzon, 2002)

At the country level, the finance literature has documented that corporate governance is a prerequisite condition for economic growth. La Porta et al. (1997) find that the countries with the higher scores in corporate governance exhibit higher valuations and breadth of debt and equity. This suggests that the development of financial markets is strongly linked to the level of corporate governance. At the firm level, better corporate governance is associated with higher market valuations (Gompers, Ishii & Metrick, 2003) and operating performance (Brown & Caylor, 2004; Klapper & Love, 2004). Complementarily, the lack of corporate governance has been claimed as raising economic vulnerability and decreasing a firm's value. Johnson et al. (2000) find that the countries with the poorest corporate governance in East Asia were the most badly affected by the Asian economic crisis in 1997,¹ while the work of Mitton (2004) reveals that firms with poorer corporate governance experienced lower performance during the crisis.

Agency theory views corporate governance as a device to limit the self-interest behaviour of the agent (Denis & McConnell, 2003). This theory assumes that a firm's value is inversely related to the opportunistic behaviour of the agent. Therefore, better

¹ Johnson et al. (2000) suggest that corporate governance has higher predictive power to this crisis than macro economic indicators and that worse economic prospects result in more expropriation by managers and thus a larger fall in asset prices in countries with weak corporate governance.

corporate governance is believed to have a significant association with higher firm performance. According to Denis (2001) and Gillan (2006), corporate governance consists of several devices which could be broadly categorised as either internal or external mechanisms (see Section 2.4 for further discussion). This notwithstanding, they suggest that the board of directors is at the apex of governance mechanisms responsible for protecting shareholders' interests.

This study investigates the effect of board composition on firm value in Indonesia. Specifically, the study examines various aspects of board composition, such as the proportion of independent directors, leadership structure and board size. The theoretical framework and hypotheses development are derived from agency theory (see Chapters 2 and 5 for further discussion). The research paradigm follows realism as the ontological choice and the epistemology borrows from the positivism approach (see Section 6.2 for further discussion).

1. 2. Corporate Governance Issues in Indonesia

Indonesia was severely hit by the East Asian economic turmoil that erupted in late 1997 (Patrick, 2001). As the absence of sound corporate governance was the main source of the crisis (Asian Development Bank (ADB), 2000), the finding of Patrick (2001) indicates that there is a lack of corporate governance adopted by Indonesia. The work of Nam and Nam (2004) confirms such a notion, as they find that Indonesia exhibits the lowest score for corporate governance among East Asian countries. Accordingly, corporate governance is of considerable importance for Indonesian firms.

The crisis has reinforced the importance of corporate governance in the economic recovery process. According to the National Committee of Corporate Governance (NCCG), such recovery requires both domestic and foreign investment and such investments being contingent upon the presence of good corporate governance. Consistent with this view, a survey by McKinsey (2001) indicates that corporate governance is perceived by market participants in Indonesia as the most important factor affecting their investment decisions. The same survey reveals that a company with good corporate governance is afforded a 27% potential premium by the investment market.

These findings indicate that there is strong demand for sound corporate governance in Indonesia.

In response to the crisis, the government has conducted corporate governance reform, such as the establishment of the NCCG and a reorganisation of the legal system designed to promote sound practice. The NCCG believes that an appropriate corporate governance system in Indonesia will encourage both domestic and foreign investments necessary to enhance economic recovery. As part of the reform, the NCCG endorsed the Code of Good Corporate Governance. In line with this code, the Capital Market Supervisory Agency (CMSA) and the Jakarta Stock Exchange (JSX) officially require that listed firms' boards comprise at least 30% independent directors, or that the number of independent directors be proportional to the shareholding by minority investors, whichever is higher. According to the agencies, this requirement is needed to assure market participants that the authority agencies are aware of the fundamental problems experienced by firms in Indonesia.

Indonesia is not exceptional in requiring that a proportion of directors serving on a firm's board be independent. Several countries outside the UK and US have advocated or mandated a minimum standard for the inclusion of independent directors on the boards of listed companies (Dahya & McConnel, 2005). More recently, regional organizations such as the Organization for Economic Co-Operation and Development (OECD) in Europe and the ADB in Asia have also encouraged member countries to adopt such recommendations toward a more prominent role for outside directors (Nowland, 2008). This prescription typically requires the firms to increase the representation of independent directors on the boards. As Dahya and McConnel (2005) observe, the movement toward greater outside director representation underlines the presumption that boards with more independent directors tend to make better decisions.

1. 3. Significance of the Study

1.3.1. Institutional Setting

Although academic research has addressed the association between board composition and firm performance, these studies have mostly investigated firms operating in developed economies, particularly the US. Vafeas and Theodorou (1998) suggest that the US results regarding the board-performance relationship may not be generalised. They argue that "...while the assumption of a utility-maximizing agent is universal, each country's regulatory and economic environment, the strength of capital markets, and current governance practices are different"(Vafeas & Theodorou, 1998, p.384). Different business environments, it is claimed, create distinct corporate governance and accordingly, "...comparing US models in isolation can lead to futile conclusions" (Dehaene, De Vuyst & Ooghe, 2001, p.383).

The US institutional environment is commonly cited as being characterised by strong legal protection (La Porta et al., 1999), which eventually leads to a dispersed ownership and active institutional investors, as well as a large, deep and active market (Erickson et al., 2005)². This setting enhances the simultaneous working of internal and external governance mechanisms in reducing the self-interest behaviour of agents (Brunello, Graziano & Parigi, 2003). Authors such as Matolcsy, Stokes and Wright (2004) believe that departure from the US setting has a significant impact on the firm-level governance structure, its effectiveness, and therefore, its impact on firm value³. Accordingly, Vafeas and Theodorou (1998) argue that the importance and value of various governance structures should be separately examined in each country.

The differences between the institutional settings of Indonesia and developed countries might be attributed to the investor protection provided by the legal system, the ownership structure, the financing pattern, and the market for corporate control. The Indonesian legal system imitates the Dutch legal system, which follows French civil

² Indeed, Denis (2001) and Denis and McConnell (2003) suggest that the legal system is the main feature of institutional setting and that feature characterizes the so-called "second generation of corporate governance research".

³ In the work of Klapper and Love (2004), institutional setting is referred to as country-level governance mechanism.

tradition (see section 4.2 for further discussion). This tradition provides investors with poor protection due to judicial discretion and narrow application of duty of loyalty and duty of responsibility (Johnson et al., 2000), which eventually creates ownership concentration and a specific financing pattern (La Porta et al., 1999; 2000). A study by the ADB (2001) indicates that the bank-oriented system is the salient feature in Indonesia, where the role of the market for corporate control is less significant and ownership is stable and concentrated in the majority owners. However, lending banks and debtors in Indonesia typically belong to the business group, which is owned by the same controlling family (Patrick, 2001). This group-affiliated financing pattern leaves the bank with less independence to monitor management action. The weak legal system and the absence of monitoring by lenders has been quoted as facilitating controlling owners pursuing their private interests with relative ease at the expense of minority shareholders and firm performance (Claessens, Djankov & Lang, 2000; Claessens et al., 2002).

In Indonesia, the ownership of firms is generally concentrated in the hands of a few families (Faccio, Lang & Young, 2001) or within a coalition between families (Shleifer & Vishny, 1997). In this environment, the agency problem arises from the divergence of interests of majority and minority shareholders, which departs from the traditional model of owner-manager conflict. Indeed, La Porta et al. (1999) find that this type of agency problem is prevalent in most economies, implying that the framework of dispersed ownership is irrelevant.

The majority-minority conflict in Indonesia is exacerbated by pyramidal and cross-holding structures, which lead to divergence between cash-flow and voting rights⁴. This wedge provides majority owners with control disproportionately greater than their investment. According to Fan and Wong (2002), the wedge lessens the incentive alignment effect and at the same time exacerbates the entrenchment problem.

⁴ Claessens, Djankov and Lang (2000) documented that approximately 80% of listed companies in Indonesia are owned by families through pyramidal shareholdings. This figure indicates that most of Indonesian firms are part of business groups. Patrick (2001) argues that the prevalence of business groups in Indonesia is a result of the link between political power and family businesses that creates crony capitalism.

Consequently, this gives the controlling owner the incentive and channel to commit expropriation. Claessens et al. (2002) find that Indonesian firms exhibit the lowest performance in Asia as a result of excessive expropriation by controlling shareholders, indicating that the agency problem in Indonesia is the most severe among Asian countries.

Another important feature of Indonesian listed firms is the existence of family-based control-enhancing mechanisms adopted by majority owners. Specifically, control of the firm by family ownership is further enhanced through the appointment of family members to serve as directors and in top management positions (Tabalujan, 2002)⁵. While Nam (2001) argues that such family-based governance minimises monitoring cost, he also argues that the "...beneficial effect of large shareholders can be expected only when the management is separated from ownership or when proper corporate governance mechanisms are in place and operating so that outside shareholders can effectively oversee corporate management" (Nam, 2003, p.2). A study by ADB (2000) indicates that these conditions are generally not fulfilled in most Asian enterprises. Therefore, family involvement on the board and in management raises an empirical question concerning the impact of such involvement on the association between internal governance mechanisms and firm performance.

Although the prevalence of family involvements in management and control decisions in East Asia has been documented, empirical studies directly and fully addressing this issue are limited. For example, Klasa (2002) focuses on the involvement on the board, while Brunello, Graziano and Parigi (2003) emphasise the role of Chief Executive Officers (CEO) who are family members of controlling-owner. This study shares some similarities with the work of Yeh (2005), Yeh and Woidtke (2005), and Yeh, Ko and Su (2003), but these more recent studies aggregate such involvements and focus on the direct effect of such on firm performance. Accordingly, this dissertation further examines the impact of these involvements on the overall effectiveness of monitoring

⁵ The work of Claessens, Djankov and Lang (2000) offers supportive evidence to this proposition as they find that the presence of managers from the controlling family are positively related to the concentration of control.

roles by the board in terms of the firm performance. Furthermore this dissertation argues that such involvement might create a combined leadership although officially Indonesia has mandated that firm adopt a two-tier board system. Given the fact that there is no empirical work incorporating this issue, the study is expected to significantly contribute to filling gaps in governance literature in relation to Indonesia.

1.3.2. Methodological Issue

The common features of Asian economies are the prevalence of ownership concentration and reliance on external financing (Claessens et al., 2002). Despite these similarities, the level of investor protection varies across countries and raises an endogeneity problem between the governance arrangement and its institutional environment (Klapper & Love, 2004). Joh (2003) suggests that a single-country study is more beneficial, in that through maintaining the same institutional setting it eliminates the endogeneity problem. Thus, by focusing on Indonesian listed firms, this study will eliminate endogeneity issues.

Theoretically, effective monitoring by the board will be reflected in better performance of the firm. However, the empirical studies reported arrive at inconclusive findings where such findings might be attributed to interdependence and endogeneity issues. Interdependence refers to the substitutability and complementary relationships among governance mechanisms which constrain empirical studies to investigating the association between particular governance mechanisms and firm performance in an isolated context (Rediker & Seth, 1995). Endogeneity refers to the direction of causality between the existing governance mechanisms and prior firm performance that might lead to spurious correlation and therefore complicate the interpretation of empirical findings (Hermalin & Weisbach, 1998; 2003). In addition, Block (1999) raises a non-linearity issue in the association between the board and firm performance. By controlling for these issues, this study is intended to overcome the shortcomings of previous research.

1.4. Key Concepts

The key concepts are derived from agency theory that hinges upon the separation between ownership and control in corporations (Fama, 1980). Such separation raises the agency relationship, where the principals delegate responsibilities to the agents (Baiman, 1990). The agent and principal enter a mutually agreed contract that is incomplete in nature (Shleifer & Vishny, 1997). Within agency theory, individuals are assumed to be motivated solely by self-interest (Jensen & Meckling, 1976). The incomplete contracts and self-interest behaviour potentially prevent the formulation of a cooperative solution among contracting parties to achieve the firm's objectives (Baiman, 1990).

The separation of ownership and control creates the divergence of interests of the principals and the agents (Jensen & Meckling, 1976). Shareholders could promote the assurance that their interests are respected by management through establishing an internal governance mechanism responsible for control decisions whenever such mechanism is independent of management (Fama & Jensen, 1983). The independence property will enable this mechanism to conduct the objective assessments of management performance that increase the sensitivity of management performance to the disciplinary action provided by the market for corporate control. Eventually, an independent internal control mechanism is more likely to better align the interests of the agent with those of the principal. As control reduces the opportunistic behaviour of the agent, all else being equal, the resultant lower potential agency cost will lead to better firm performance.

Corporate governance consists of several devices or mechanisms that could be broadly categorised as either being internal or external (Gillan, 2006). Nevertheless, governance mechanisms might complement or substitute for each other, where various specific governance configurations are possible to produce similar outcomes (Danielson & Karpoff, 1998). The substitution argument implies that board monitoring would be considerable importance in the absence of other governance mechanisms while the complementarities argument suggests that board monitoring role would be effective whenever other strong governance mechanisms exist (Agrawal & Knoeber, 1996).

Accordingly, all else being equal, the relationship between board composition and firm performance is more likely to be affected by the presence of alternative governance mechanisms.

An optimal control system might be achieved whenever there is a balance of power between the agent and the principals (Jensen, 2000). If the power is concentrated in the agent, it might prevent the labour market for corporate control to discipline management (Fama, 1980; Fama & Jensen, 1983). The absence of the threat of dismissal as a necessary condition for corporate control discourages managers from pursuing such action that would maximize the interests of principals (Fama, 1980). Under this circumstance, the manager might prefer to choose the optimal self-interest behaviour that is detrimental to firm performance and shareholders' wealth. All else being equal, the effectiveness of the board in improving firm performance through their monitoring role would be reduced whenever the power is concentrated in the agent.

1. 5. Research Objectives

The purpose of this study is to investigate the association between board composition and firm performance in the context of Indonesia that has been identified as being characterized by a specific institutional environment. The accounting rate of return is the measure and benchmark for firm performance. This measure has been selected, as a meta-analysis by Rhoades, Rechner and Sundaramurthy (2000) find that accounting measures produce a consistent relationship between board composition and firm performance as compared to those of market-based performance indicators. Specifically, the objectives of the research are as follows:

1. To examine whether the presence of independent directors serving on a board has a positive association with firm performance.
2. To investigate whether the presence of an independent director serving as chairman of the board has a positive association with firm performance.
3. To determine whether the association between board composition and firm performance is moderated by control-enhancing mechanisms of controlling shareholders.

4. To examine whether the association between board composition and firm performance is moderated by the presence of external large shareholders.
5. To investigate whether the association between the above variables and firm performance is influenced by firm size, leverage, and industry type.

1. 6. Research Strategy

There are two alternative underlying assumptions in investigating the association between board composition and firm performance. The first posits that board composition is endogenously determined by internal and external factors. The cost and benefit of particular board composition are specific to the firm and the board composition reflects the trade-off between cost and benefit for that particular firm. This implies that corporate governance mechanisms vary across the firm systematically and depend on the firm's specific needs. This line of reasoning hinges upon the view that firms have selected a particular composition of their boards of directors that is appropriate to their need. Accordingly, the likelihood of an empirical relationship between board composition and firm performance is reduced.

The alternative assumption is that certain board composition is appropriate for all firms. Consequently, firms that do not demonstrate such specific governance configurations will have lower value. This line of reasoning is based on the presumption that governance configuration within a particular firm is determined by the distribution of power between the contracting parties. Accordingly, it is possible that firms adopt sub-optimal governance mechanisms in order to accommodate the interest of particular contracting parties at the expense of others. Under this view, there is likely to be an empirical relationship between board composition and firm performance.

As previously mentioned, a study investigating the association between board composition and firm performance might follow one of two competing assumptions. The first posits that board composition is endogenously determined by internal and external factors implying that the likelihood of an empirical relationship between board composition and firm performance is reduced. The alternative assumption is that certain

board composition is appropriate for all firms suggesting that there is likely to be an empirical relationship between board composition and firm performance. Although such competing assumptions exist, studies in emerging markets remain to support the assumption that governance mechanisms drive organizational outcome. For example, the score of corporate governance index has been documented as having a positive impact on firm performance (Klapper & Love, 2004), firm size (Beck, Demirgüç-Kunt & Maksimovic, 2003), and firm value (Durnev & Kim, 2002). In the case of South East Asia, the interaction between firm-level and country-level has been documented as having a negative association with the incentive of controlling owners to deprive minority shareholders from their rights. Nowland (2008) provides a more convincing support to the assumption of the existence of empirical relationship between board composition and firm performance. After controlling for the endogeneity issue, as an internal validity consequence of the competing assumption, he finds that board compositions affect firm performance. Indeed, The World Bank (2005) finds that the lack of governance mechanisms, in general, and ineffective boards, in particular, are the salient features of Indonesian firms. Thus, minority shareholders are afforded less protection against excessive expropriation by controlling owners. This finding implies that Indonesian firms choose sub-optimal governance configurations that best suit the interest of controlling shareholders in the contracting environment. As such, this study follows the assumption that certain board composition is suitable for all firms, and therefore, that an empirical relationship between board composition and firm performance exists.

The competing assumptions of the relationship between governance and organizational outcome have been claimed as raising endogeneity problem that, eventually, complicate the interpretation of empirical results (see section 3.2.2.4 for further discussion). Indeed, endogeneity problem, which refers to the direction of causality on the relationship between governance and firm performance, is a major concern for firm-level variables that inherently plagues empirical governance studies (Drobetz, 2003; Black, Jang & Kim, 2004, 2006). Nevertheless, literature suggests various methodological approaches to control for such a problem. Therefore, although it is assumed that that empirical relationship between board composition and firm performance exists, this dissertation

controls for endogeneity problem by using lagged data for independent and dependent variables (Dherment-Ferere & Renneboog, 2000) and applying two step least squares (2SLS) (Seifert, Gonenc & Wright, 2005) to address such an issue (see section 8.4.2.4 for further discussion).

According to Bhagat and Black (2002) two approaches may be taken in investigating the association between board composition and firm performance. The first investigates board composition and its decision-making process in discrete tasks such as CEO turnover, executive compensation, and takeovers. The second approach directly examines the effect of board composition on overall firm performance. However, Hermalin and Weisbach (2003) note that the effect of certain board composition on firm performance is less likely to be detectable, as firm performance is a function of so many different factors. Hence, they contend that a cleaner test is required in investigating such relationships in order to control for the firm-specific effect and directly test for the desired effect. Further, they believe that a more successful measure would be the impact of changes in board composition on firm performance.

It has been asserted that corporate governance was not a significant concern in Asia until the Asian crisis has prompted the importance of corporate governance (Nowland, 2008). He suggests that board composition in Asia simply reflect the interest of controlling owners and implies that representation by an outside director was the exception rather than the norm in such firms prior to the Asian crisis. Accordingly, it might be argued that the inclusion of independent directors serving on boards in Indonesian firms has been triggered by the requirement to appoint independent directors endorsed by the CMSA and JSX. Consequently, this requirement provides a natural setting in which to investigate the effect of changes in board composition. As such, this study will adopt a direct approach in examining the association between board composition and firm performance.

1. 7. Research Method

The starting point of the data constructions is the companies listed on JSX as of 31 December 2002, the date independent directors became mandatory. This study uses cross-sectional data consisting of 190 non-financial companies listed on the JSX in 2002 (see Section 6.3.2 for further detail). This period is selected as it produces the data that enables examination of the effect of board composition on firm performance. The dependent variable is the firm performance measured using Return on Assets (ROA) and Return on Equity (ROE). The independent variables are the proportion of independent directors, board leadership structure, board size, ownership structures, and controlling-family involvement in management and in the board and control variables (see Section 6.3 for further detail). Analysis will use ordinary least squares to enable this study to conduct the multivariate tests necessary for the hypothesis testing (see Section 6.3 for further discussion).

1. 8. Organization of the Thesis

The thesis is organized as follows. Chapter 2 presents theory related to the board of directors and its association with firm performance. Chapter 3 discusses the related empirical literature discussing the association between the board of directors and firm performance. Chapter 4 reviews the institutional setting of Indonesia. Chapter 5 develops the testable hypotheses. Chapter 6 discusses the research method. Chapter 7 identifies statistical assumptions and provides a summary of descriptive statistics. Chapter 8 presents univariate and multivariate analyses. Chapter 9 discusses conclusions of the study and policy implications.

Chapter 2: Literature Review

2.1. Introduction

In the previous chapter, the purpose of the thesis, the research questions, and the significance of the study are presented. This chapter discusses the agency theory underlying the study, corporate governance and the board of directors. The purpose of this chapter is twofold. The first is to provide a deeper background to agency theory, agency conflict, and the mechanisms to overcome such conflict. The second is to provide a basis for developing hypotheses on the association between board composition and organisational outcomes in relation to Indonesia (see Chapter 5). The chapter starts with agency theory and the nature of agency problems. The subsequent sections discuss corporate governance emphasizing the role, property and leadership structure of the board of directors. The last section summarises the discussion

Indonesian listed firms are characterized by ownership concentration in the hand of controlling families (see Chapter 4 for further detail). Further, the controlling owners typically appoint their family members to serve on the board and in management (see Chapter 4 for further detail). Such characteristics might have important implications for the separation of management decisions and control decisions. Therefore, such control potentially affects the nature of board independence and the association between internal governance mechanisms and firm performance. Accordingly, this chapter also discusses family ownership and family involvement on the board and in management.

2.2. Agency Theory and the Nature of Agency Problems

Agency theory posits that an agency relationship exists whenever one or more individuals (principals) hire another person (agent) to perform a service (Jensen & Meckling, 1976). The principal and agents enter a mutually agreed contract, which specifies the rights and responsibilities of each party. Jensen (1993) suggests that agency relationships hinge upon the proposition of separation of ownership and control, which was firstly observed by Berle and Means (1932) in joint-stock companies. The separation of ownership and control becomes a norm of modern corporations as it

creates an efficient form of economic organization (Fama, 1980). This separation leads to a transfer of corporate control from the corporate owner to professional managers. Within this framework, a firm serves as a nexus of contracts between various parties (Jensen & Meckling, 1976) to coordinate different factors of production in order to achieve a specific goal (Alchian & Demsetz, 1972)⁶. Accordingly, the firm's outcome is determined by its production factors (Fama & Jensen, 1983).

Agency theory assumes that individuals are motivated solely by self-interest, which may be conflictive where "...cooperative behaviour in maximizing the welfare of the principal is not consistent with individual self-interest" (Baiman, 1990, p. 342). This view is based on the premise advanced by Jensen and Meckling (1976, p. 308) who state that "...if both parties to the relationship are utility maximisers there is good reason to believe that the agent will not always act in the best interests of the principal". This premise implies that the agents necessarily prefer to maximize their wealth and this preference potentially diverges from the preferences of shareholders⁷.

Agency relationships rely on the contract as the first best solution in order to mitigate the divergence of interests between those of contracting parties (Hart, 1995)⁸. However, Baiman (1990, p. 346) suggests that the contracting parties "...do not have unlimited computational ability" to acquire and process information. This view implies that it is impossible for individuals to foresee all possible future contingencies and incorporate them into the contract. Therefore, agency theory assumes that the contract is incomplete in nature. Baiman (1990) argues that the divergence of interest and incomplete contracts are the main source of agents' failure to maximize the interest of the principals that eventually constitutes agency problems specific to the firm.

⁶ The nexus of contract view also "...dispels the tendency to treat organizations as if they were persons" (Jensen, 1993, 327). Consequently, the organizations have neither preference nor social responsibility (Jensen and Meckling, 1976).

⁷ Accordingly, the behaviour of the organization is the equilibrium behaviour of a complex contractual system made up of maximizing agents with diverse and conflicting objectives. In this sense, the behaviour of an organization is like the equilibrium behaviour of the market (Jensen 1993).

⁸ Contract is assumed to be incorporated ex-ante. The agent is assumed to be risk-averse and work-averse and therefore the agent tends to limit the sensitivity of their wealth relative to the outcome of the firm when a contract is incorporated.

It has been argued that the nature of agency problems depends on the ownership structure within the firm as such structure determines the distribution of corporate control among contracting parties (La Porta et al., 1999). Based on the work of Berle and Means (1932), the first generation of the governance literature assumes a dispersed ownership in public corporations (Denis, 2001; Denis & McConnell, 2003). In the dispersed firms, large numbers of shareholders have only a small fraction of ownership individually. This implies that individual shareholders will bear the higher cost and reap only a small fraction of the benefit of monitoring effort. Therefore, in this situation, shareholders are less likely to monitor managers given the higher monitoring cost. If all shareholders adhere to this view, corporate control will rest in the hands of management, which has an incentive to increase their perquisites. Eventually, it is believed, the 'free-rider problem' associated with dispersed ownership will become the main cause of weak, diffused shareholder control (Shleifer & Vishny, 1986). Agency problems in such firms spring from the conflict between powerful management and the disempowered dispersed shareholders.

However, academic research has documented the prevalence of ownership concentration in most economies. For example, La Porta et al. (1999) find that ownership by the top three largest shareholders is a feature of 46% of the larger non-financial firms in 49 countries. In the concentrated firm, majority shareholders have sufficient voting power to influence a firm's operation. Accordingly, the control of the firm will rest in the hands of majority shareholders, who have the power and incentive to exercise expropriation in relation to minority shareholders. This finding challenges the assumption of dispersed ownership and implies that the dispersed ownership assumption becomes an irrelevant framework. The irrelevance of the framework of dispersed ownership is reinforced by Shleifer and Vishny (1997) claiming that the dominant agency problem in most countries is related to the conflict between majority and minority shareholders, rather than shareholders and managers.

2.3. Agency Theory and Corporate Governance

The basic model of agency theory predicts that the shareholders' wealth is inversely related to the self-interest behaviour of the agents (Jensen & Meckling, 1976) where such behaviour might be mitigated by the presence of corporate governance (Denis, 2001)⁹. In the earlier literature, the dominant view of corporate governance hinges on the conflict between manager and shareholders. However, Gillan (2006) suggests that agency problems may also stem from conflict between managers and the various stakeholders as each contracting party has their own interests, and these interests may differ from those of others involved. Accordingly, this study defines corporate governance as a check and balance system that assures that one party will not benefit at the expense of others. This might be achieved whenever such system enables various stakeholders to exert "...control over the corporation by exercising certain rights" (John & Senbet, 1998, p. 374). This view implies that corporate control is the most important aspect of corporate governance.

Mizruchi (1983) observes that the finance literature has underlined the importance of differentiating between management and control. In the work of Thompson (2003, p. 32) control is defined as the "...function in industry concerned in the determination of the corporate policy and...affecting the executive". In a similar vein, Scott (1974, p.37) suggests that the concept of control hinges upon the authority to define the "...sphere of decision which concerns the basic parameters within which the corporations forming a particular unit of capital are to act". On the other hand, management refers to "...activities which relate to the sphere of decision concerning the implementation of corporate strategy and hence to the immediate day-to-day administration of company operations" (1974, p.37). Similarly, Thompson (2003, p. 32) suggests that managing refers to "...the execution of policy, within the limits set up by administration, and the employment of the organization for the particular objects set before it". Therefore,

⁹ While Allen and Gale (2002) identify two distinct models of corporate governance - namely, Anglo-Saxon and Continental European - the OECD (2004, p. 13) suggests that "there is no single model of good corporate governance". According to Maher and Andersson (1999), the underlying theory of corporate governance dictates its model and definition.

managing could be seen as day-to-day decision making (implementation), which is derived from strategic policy (basic parameters).

In a related distinction, Fama and Jensen (1983) suggest that the decision process consists of initiation, ratification, implementation and monitoring. Initiation and implementation are in the domain of management decisions, while ratification and monitoring are control decisions. They believe that management decisions should be separated from control decisions in constructing a proper check and balance system. This view implies that combining the two decisions in the hand of managers facilitate them to pursue opportunistic behaviours. In this context, corporate governance is intended to adequately ensure that management decisions are separated from control decisions so that it enables the shareholders to influence the policy decision within the firm through establishing strategic policy and basic parameters. In other words, corporate governance mechanisms serve as the devices through which shareholders retain corporate control and influence management decisions in order to ensure that their interests are well respected.

2.4. Corporate Governance Mechanisms

Agency literature classifies the governance mechanisms into two main categories: internal and external (Denis, 2001)¹⁰. External mechanisms rely on the market for corporate control to discipline the firm (Jensen & Ruback, 1983; Borio et al., 2004) and the legal system that serves as a country-level governance mechanism providing investors with particular protection (La Porta et al., 1998; 2000) while internal mechanisms refer to large shareholders (Jensen & Meckling, 1976; Shleifer & Vishny, 1986) and boards of directors (Wagner III, Stimpert & Fubara, 1998)¹¹.

¹⁰ Dennis and McConnell (2003), Denis (2001), Claessens and Fan (2002) and Gillan (2006) use this classification in their literature survey although the focus and depth of discussions varies across studies. Denis (2001, p. 197) argues that "... while the lines between these categories are not perfectly distinct, they do provide a useful base categorization scheme".

¹¹ Although executive compensation schemes and governance provisions might serve as the governance devices, such scheme and provisions have been quoted as being endogenously determined by the board composition and ownership structure. See for examples Core, Holthausen and Larcker (1999), Ryan Jr. and Wiggins III (2004), and Mallette and Fowler (1992). In addition, Gul (2001) argues that leverage might serve as a governance mechanism as it leads to the lender monitoring.

2.4.1. Legal System

The legal system has been referred to as a country-level governance mechanism in the finance literature¹². Doidge, Karolyi and Stulz (2007) suggest that the legal system affects the cost to firms in adopting a particular governance configuration, and the benefits derived there from, suggesting that country-level governance determines the firm-level governance. The work of Krishnamurti, Sevic and Sevic (2005) confirms such a notion and finds that the firms operating in the countries with a strong legal system have a higher score of firm-level governance. However, firms operating in countries with a weak legal system might adopt strong firm-level governance in order to compensate for inadequate investor protection provided by the legal system (Klapper & Love, 2004). According to Durnev and Kim (2002) this strategy will benefit the firms in their abilities to raise external capital.

Fan and Wong (2002) suggest that shareholders and creditors are willing to finance a firm because they have the right to influence management decisions and extract a return on their investment from the manager. According to Beck and Levine (2003) the law and its enforcement determine the ability of financial suppliers to exercise their rights where these rights are necessarily exercisable in the presence of strong investor protection provided by the legal system. Consequently, a strong legal system will encourage financial suppliers to finance the firm's operations. This view has been confirmed by empirical studies documenting a positive relationship between a strong legal system, the valuation and breadth of both debt and equity (La Porta et al., 1997) and financial market development (Beck & Levine, 2003).

As La Porta et al. (1998) observe, the effectiveness of legal systems in protecting investors is substantially determined by the origin of the legal tradition, which could be broadly characterized as being either civil or common law. In French civil law, political power heavily determines the development of codification and, accordingly, such a law restricts the judicial system to pursuing a discretionary interpretation of duty of loyalty

¹² See, for example, Himmelberg, Hubbard and Love (2004), Dyck and Zingales (2004), Boutchkova (2003) and Durnev and Kim (2005).

and duty of responsibility concepts (Johnson et al., 2000). Consequently, a civil law tradition narrowly applies such concepts, which lessens its adaptability to other precedents and environments (Beck, Demirgüç-Kunt & Levine, 2003). In contrast, common law provides the judicial system with a higher discretionary capacity because such law is codified by the judges based on their sense of justice (Johnson et al., 2000). The lower discretionary powers applicable in civil law thus provide investors with less protection than the common law tradition (La Porta et al., 1998). Johnson et al. (2000) find that, even in the developed countries, the civil law system is less preventive of expropriations by controlling shareholders through self-dealing and share dilution.

Agency theory suggest that corporate shares are a property arrangement providing shareholders with power (through voting rights) and incentive (through cash flow rights) to negotiate and enforce contracts with various parties (Fan & Wong, 2002). La Porta et al. (1999) argue that property rights can be enforced by the state and shareholders. In economies where property rights enforcement by the state is weak, the shareholders will enhance the power of enforcement through increasing and accumulating ownership of the firm. This view implies that ownership concentration will be observed in an environment where property rights enforcement by the state is weak (La Porta et al., 1999). According to Shleifer and Vishny (1997), the benefits of ownership concentration are larger in less developed countries where property rights are not well defined and protected by the judicial system.

2.4.2. Market for Corporate Control

Agency theory posits that the separation of ownership and control is an efficient form of modern corporations, where the viability of such separation hinges upon the role of an efficient market for corporate control (Fama, 1980). Within this framework, the market serves as the ultimate device in disciplining production factors and providing incentives such that these factors combine to achieve acceptable outcomes (Alchian & Demsetz, 1972). Consistent with this view, Kaen (2003) posits that an efficient market for corporate control provides continuous pressure that forces management to perform

better. The market for corporate control consists of a corporate market (Manne, 1965), labour market (Alchian & Demsetz, 1972), and product market (Hart, 1983)¹³.

The product market reflects the first layer of signals of the managerial performance to produce a competitive product. According to this framework, the performance of the product, and therefore of management, will be reflected in the share price of the firm. A lower price signals poor performance of the product in the market and underperforming management¹⁴. The market will respond by replacing management accordingly through the manager market for corporate control. Nevertheless, the removal of poorly performing managers might be facilitated by a corporate market for corporate control (Jensen & Ruback, 1983)¹⁵.

The inefficiencies and failure to maximize firm performance have been quoted as exposing the company to the corporate market for corporate control that may consequently remove inefficient management (Maher & Andersson, 1999). According to Berglöf and Claessens (2004), the corporate market for corporate control, which operates through mergers and acquisitions, enables potential owners to take over a firm and correct management failure not addressed by existing owners. They believe that “...the mere prospect of such a hostile takeover could influence management even if it never happened” (Berglöf & Claessens, 2004, p.11). This view implies that the ultimate objective of the market for corporate control is to provide management with sufficient incentive to pursue value-maximizing behaviours and to ensure that management performs well.

¹³ See also Jensen & Ruback (1983) for the literature review.

¹⁴ The value of the share price provides information to the labour market in revaluing management performance (Fama, 1980).

¹⁵ McColgan, (2001) argues that although takeovers might be motivated by either efficiency gains or disciplinary mechanism, the finding of empirical studies is commonly consistent with the disciplinary hypothesis towards managers who fail to maximize shareholder’s wealth.

2.4.3. Board of Directors

2.4.3.1. The Role and the Properties of the Board

The board of directors has appeared in the finance literature as an internal institution representing shareholders in governing the firm. According to Dahya and McConnell (2005), regulations in most economies commonly require listed firms to establish a board of directors in accordance with specific compositional requirements. These requirements underline the argument that views the board as a legally induced institution and thus the presence of a board departs from economic rationale¹⁶. Alternatively, Jensen (1993) argues that the presence of a board of directors is a market induced mechanism representing production factors, although it is almost impossible to expect that this representation is naturally shown up in the board. Under this view, the specific task of the board is to articulate shareholders' objectives through establishing goals and procedures, control systems, and strategic decision making (Zahra & Pearce, 1989). This view is based on the premise that voice is more important than exit strategy, since the latter is a weak defence against management interests (Maug, 1998). In this circumstance, the board represents shareholders' interests in order to ensure that such interests are articulated in the decision making process within the firm. However, the agency framework claims that the board is primarily assigned as a control device in relation to management decisions (Hung, 1998). According to Jensen (2000, p. 49), the ultimate goal of internal control mechanisms is to provide a "...early warning system to put the organization back on track before difficulties reach a crisis stage"¹⁷.

Control responsibility implies that the board is responsible for strategic decision-making, which is concerned with the basic parameters regarding the action of particular corporate units (Scott, 1979). According to Smith and Walter (2006), control constitutes power, which Mizruchi (1983) defines as a latent process, the consequences of which are felt, but possibly empirically unobservable. Eventually, the power enables the holders "...to define the boundaries within which decisions can be made and...allow subordinates to

¹⁶ Hermalin and Weisbach (2003) argue that if this is true, the board, as an internal institution, may be absent in some countries where the existence of the board is not required by the law.

¹⁷ Agency theory predicts that firm value is an inverse function of agency cost associated with the perquisite taking by the agent. Accordingly, minimizing agency cost is consistent with maximizing the residual claim of shareholders (Kang & Sorensen, 1999).

make decisions” (Mizruchi, 1983, p.428). This view suggests that the board might leave the operational course of strategic policy to management while the power to influence management decision remains in the hands of the board (Bunting & Mizruchi, 1982). In this context, a corporate board is intended to control management decisions in order to ensure that such decisions are consistent with the interests of the principal. Mizruchi (1983) argues that the board will possess actual power whenever they have the authority to select, evaluate and replace management, where removing management is the most important authority since it grants the board the bottom line of control.

According to Fama and Jensen (1983), the effectiveness of board monitoring determines the level of agent perquisite taking. For Alchian and Demsetz (1972), monitoring refers to the activity which assesses the outcome of a production team’s effort, determines whether the outcome is suitable to a certain standard and disciplines production factors which perform below standard¹⁸. Such activities comprise intervention in certain company operations and acquisition of information to identify the target area of intervention (Maug, 1998)¹⁹. Fama (1980) and Alchian and Demsetz (1972) believe that monitoring potentially discourages agents from pursuing opportunistic behaviour and therefore induces them to achieve higher performance. They suggest that monitoring enhances the sensitivity of agents’ performance to the labour market for corporate control, where disciplinary action and opportunity offered by the market will provide sufficient incentive for agents to pursue actions consistent with the targeted outcome. Accordingly, the ultimate outcome of effective monitoring is higher firm performance.

Despite its benefit, there are costs associated with monitoring effort. Jensen and Meckling (1976) suggest that the principal will choose to adopt a monitoring mechanism whenever its cost is less than the decrease in the value of equity. They believe that maximizing the value of equity provides an incentive to the principal to monitor management. In a similar vein, Fama (1980) argues that lower-cost monitoring mechanisms are likely to survive in a competitive environment. Within this view, the

¹⁸ Fama and Jensen (1983) differentiate between ratification and monitoring as the elements of control. Although the terms used are different, they are similar in substance.

¹⁹ In a broader sense, monitoring refers to all value-enhancing activities (Maug, 1998).

board could be seen as a monitoring device to discipline management, lower in cost than other mechanisms such as the market for corporate control. For example, a takeover process might be expensive and time consuming (Denis, 2001), while the product market provides signals only when the failure of management to deliver efficient product is evident.

Agency theory posits that the boards would effectively perform their monitoring role whenever they are independent of management (Dalton et al., 1998). Independent incorporates a self-determining concept, in which the fate of directors is unconstrained by management decisions. The unconstrained property is a necessary condition enabling the board to exercise objective judgment of managerial performance that enhances the market mechanism for low-cost transfer of control (Fama, 1980)²⁰. This view implies that the monitoring role is best performed by independent directors who have no affiliation with management (Rahejaa, 2003), where the higher representation of independent directors is believed as encouraging the separation between management decisions and control decisions. Consequently, the board would be in a better position to exercise a monitoring role whenever it comprises sufficient independent directors (Adams & Ferreira, 2007). Based on this proposition, many countries have taken heed of the call for more independent directors, assuming that this will lead to better decisions (Dahya & McConnel, 2005).

Complementary to the independence, Coles, Daniel and Naveen (2008) suggest that the boards might benefit the firms whenever the directors have sufficient knowledge regarding the projects being ratified and monitored. This property enables the board to pursue an accurate assessment of the project proposed by management. According to Rahejaa (2003), the information property determines the effectiveness of the board-monitoring role in replacing inferior projects with superior ones, and therefore permits the board to prevent the firm from benefiting management at the expense of shareholders. Eventually, independent directors with sufficient knowledge will lead to a more active board in challenging management proposal and thus better protect

²⁰ See also Clarke (2007) for further discussion on the concept of director independence.

shareholders' interest (Millstein & MacAvoy, 1998). However, Adams and Ferreira (2007) claim that management naturally has superior information surrounding the projects. In this circumstance, the board might face an information asymmetry problem, conditional on the presence of particular mechanisms which enhance better information flow from management to the directors. This mechanism might be achieved through establishing an appropriate board composition and leadership structure.

2.4.3.2. Board Model and Leadership structure

According to Hopt and Leyens (2004), there are two distinct board models: the unitary system and the two-tier system²¹. In the one-tier system, shareholders elect the directors, which in turn appoint management. This system allows executives to serve on the board, which thus comprises both executive and non-executive directors. This dual role is believed to have two competing effects. The presence of executive directors might enhance information flow between board and management, and therefore might mitigate information asymmetry (Rahejaa, 2003). However, dual roles might reduce board independence and therefore compromise its monitoring role. Commenting on this dual role, Adams and Ferreira (2007) suggest that executive directors might experience a trade-off in disclosing information to the board. If the management reveals sufficient information to the board, the manager may obtain better advice, but will be accurately scrutinized by the board. This provides the manager with the incentive to conceal sufficient information to the board in order to avoid accurate monitoring. In this circumstance, the board may commit to reducing monitoring in order to maintain information supply from management.

As a consequence of the dual role, firms in a unitary system might choose to adopt either combined or separated leadership. A combined or duality leadership refers to the situation where the CEO also holds the position of chairperson of the board, while separated leadership exists whenever a non-executive director serves as board

²¹ According to Bebchuk and Roe (1999), path dependent theory suggests that the governance system of a country depends on the structure when the economy began. The system spreads over the world through conquest and colonial system (Gevurtz, 2004). Accordingly, the unitary system is prevalent in Anglo-Saxon countries such as the US, UK and Commonwealth countries, while the two-tier system is commonly observed in the continental European economies and their former colonies.

chairperson (Fosberg & Nelson, 1999). Agency literature suggests that leadership structures have important implications for the board's independence and therefore the effectiveness of their monitoring role. This view is grounded on the premise that the board chairperson has the authority to organize board activity and therefore grants the chairperson the greatest influence over the board. Nevertheless, both leadership structures have their own advantages and disadvantages.

Proponents of separated leadership argue that the chairperson and the CEO have different roles and that these should be separated (Dalton et al., 1998). Fama and Jensen (Fama & Jensen, 1983) claim that CEO duality signals the absence of separation of management decisions from control decisions so that it reduces the firm's competitiveness for survival. Moreover, Baliga, Moyer and Rao (1996) posit that combined leadership grants management the ability to influence board composition and tenure, set board meeting agendas, control information flows and influence the development of corporate strategy. This, in turn, enables management to control the board, and accordingly, prevents the board from monitoring management effectively (Zajac & Westphal, 1994). Consequently, the lack of board independence associated with combined leadership will hamper the board in its capacity "...to respond early to failure in its top management team" (Jensen, 1993, p.866). Therefore, the presence of duality implies that management actually defeats the check and balance system that enhances managerial entrenchment.

However, separated leadership might dilute managerial power "...to provide effective leadership by increasing the probability that actions and expectations of management and the board are at odds with each other" (Baliga, Moyer & Rao, 1996, p.42). This might create potential rivalry between the board chairperson and the CEO, which limits innovation and entrepreneurship by the CEO because the board and the CEO might have different perspectives and time-horizons regarding the project being proposed by management. Further, separated leadership generates investor confusion, as there are two public spokespersons within the firm, the board chairperson and the CEO. In contrast, combined leadership permits clear-cut leadership, which is necessary for

strategy formulation and its implementation, and therefore might lead to superior performance

The firms in a two-tier system have supervisory and executive boards. The members of the supervisory board are elected by shareholders²². Eventually, the supervisory board elects the executive board, which is similar to the top management team in a one-tier system. The two-tier system prohibits an individual from serving in both supervisory and executive boards and therefore the supervisory boards comprise non-executive directors entirely. This dual chambers system leads to a formal separation between management decisions and control decisions (Moerland, 1995) that provides a basis for rationalizing effective monitoring by the board (Adams, 2002). Although the scope of responsibility of the board might include advisory and control duties, the formal separation suggests that the two-tier system emphasizes the monitoring role as compared to the one-tier system (Moerland, 1995). However, the modes of appointment of the supervisory board members vary across two-tier countries²³.

Based on the work of Berle and Means (1932), the first generation of the governance literature hinges on the assumption of a dispersed ownership in public corporations, where the agency problems stem from the conflict between manager and corporate owners (Denis & McConnell, 2003). However, in most economies the ownership of the firms is concentrated in the hands of few wealthy families that provide them with almost complete control of the firm (La Porta et al., 1999; Lemmon & Lins, 2003). This finding suggests that the dominant agency problem in most countries is related to the conflict between the controlling family and minority shareholders (Shleifer & Vishny, 1997) and therefore dispersed ownership becomes an irrelevant framework

The prevalence of the family control has been quoted as providing a rationale to use the family, instead of individuals, as the unit of analysis and accordingly a family-based

²² Germany follows the co-determination approach and some portions of the members of the supervisory board (Aufsichtsrat) are elected by the employees.

²³ For example, in Indonesia and Taiwan, the members of the management board are elected directly by shareholders.

approach has important implications for governance research. This approach is based on the premise that the family members of the controlling owners share the same interests and accordingly they will pursue similar and collective behaviour in the contracting environment (Urutiaga & Tribo, 2004). For example, one implication of family members sharing the same interests is that family ownership includes shareholding by the family members and by parties considered to be under the influence of the family²⁴. Put differently, the aggregate shareholdings of family members of the controlling owner are treated identically to the shareholding of a single person in the framework where individuals serve as the unit of analysis. According to Claessens et al. (2002), using the family as the unit of analysis is more beneficial as this approach better portrays the real control of the firm.

Studies investigating board composition generally follow the common practice in categorizing the directors such as insider directors, affiliated directors and independent directors (Bhagat & Black, 2002, p.2)²⁵. This categorization assumes that insider and affiliated directors are more likely to preserve the interest of management as they share the same interests. Lukviarman (2004) argues that such categorization in one-tier studies is applicable to family-controlled firms although it requires a modification. Particularly, he notes that affiliated director should be defined as the owner-related directors that might include the relatives of the controlling shareholders or individuals with personal ties with the controlling shareholders. This view assumes that the affiliated director would prefer to give assurance that the interests of the controlling family are well respected.

In the concentrated firms, the management acts solely for the controlling family and therefore potentially lead to a greater agency problem (Morck & Yeung, 2003). Following the approach using the family as the unit of analysis, the interests of family

²⁴ See, for example, Polsiri and Wiwattanakantang (2006), Villalonga and Amit (2006) and Baek, Kang and Park (2004).

²⁵ Inside directors are person who are currently officers of the company. Affiliated directors are the relatives of officers, person who are likely to have a business relationship with company such as investment bankers and lawyers, or persons who were officers in the recent past. Independent directors are outside directors without such affiliation. The differentiation between inside directors and outside directors in the Indonesian context is detailed in section 4.4.2.

members of controlling owners serving in the board might be argued as necessarily similar to those of management, which has been assumed as representing the interest of the controlling family solely. Consequently, the family as the unit of analysis has two important implications on the concept of director's independence. Firstly, the interest-sharing assumption implies that the directors of controlling family members necessarily represent the interest of their family as their fate is constrained by their family. Given that the management acts solely for the controlling family, this argument implies that such directors share the same interest with management. Secondly, the collective action assumption implies that such directors will pursue collective actions with the management in securing the interests of the controlling family. This might be achieved whenever such directors have sufficient information about the company operation. Consequently, this view suggests that the directors who are the family members of controlling-owner are unconstrained by information access. According to agency theory, the information access and the similarity of interests between those of the directors and management serve as the criteria in differentiating between independent and insider directors. This line of reasoning implies that the directors who are the family members of controlling-owners have properties identical to those of insider directors.

The board of directors is internal institution responsible for monitoring management behaviour. Such an institution might effectively monitor management whenever control decisions are separated from management decisions. This view is based on the premise that the separation will enhance the board independence of management necessary for fulfilling monitoring responsibility. Fama and Jensen (1983) claim that board leadership structure might serve as an indicator of the separation between management and control decisions. They posit that combined leadership signals the absence of the separation that potentially impairs the board independence in performing objective assessment of managerial performance. Further they argue that combined leadership exist whenever insider director, who has affiliation with management, serves as a board chairperson.

Theoretically, a combined leadership exists only in the one-tier system, where the system permits individuals to serve in both managerial and directorial roles. In contrast,

the boards in the two-tier system consist of non-executive directors entirely and therefore this system necessarily adopts separated leadership. However, it has been argued that the family members of controlling owners serving in the boards have identical properties to insider directors. Consequently, when the controlling family appoints their family members to the management team and as chairperson of the board, the outcome may be the type of combined leadership problem advanced by Jensen (1993). This argument implies that combined leadership, to some extent, is also prevalent empirically in a two-tier regime, whenever the controlling owner appoints their family members to serve as board chairperson

2.4.3.3. Board Size

Along with independent directorships and leadership structure, board size (which refers to the number of directors serving on the board) has been identified as having an impact on the effectiveness of the board in fulfilling its responsibilities. Yermack (1996) argues that boards consisting of a small number of directors operate most effectively. This view is grounded on the premise that a larger group is more likely to be prone to communication and coordination problems. Furthermore, the literature also suggests that the directors on smaller boards are less risk averse and react more quickly to changing market conditions (Lipton & Lorsch, 1992). Consistent with this view, the work of Harris and Raviv (2008) implies that smaller boards reduce potential free-riding problems associated with larger boards. Consequently, smaller boards tend to enhance discussion of important issues, rather than compliance with CEO proposals, which assists in facilitating an effective monitoring role.

However, the number of outside directors is determined by the “expertise that each additional director brings to the board compared with the cost arising from free riding that occurs with the appointment of an additional director” (Heaney, 2007, p.4). Therefore, larger boards can be beneficial where an outside director brings expertise with him/her that is appropriate to a monitoring role. Moreover, it has been argued that larger boards can have a positive impact on the advisory role. Coles, Daniel & Naveen (2008, p.334) suggest that qualities befitting such a role are “...more likely to come

from outsiders on the board.” Similarly, Dalton et al. (1999) posit that some firms need to appoint additional outside directors to ensure a quality of advice otherwise unavailable from inside directors. With the benefit of this better advice, a larger board thus enables the firm to formulate an optimal strategy in pursuing its ultimate goal.

2.4.4. Ownership Structure

2.4.4.1. Large Shareholders

Within agency theory, corporate governance is derived from the separation between ownership and control. According to Barca and Becht (2001) ownership structures determine the nature of agency conflict and therefore the very purpose of governance mechanisms. In the dispersed firm, agency problems stem from conflict between managers and owners. Within such firms, corporate governance is intended to limit self-interested agent behaviour. By contrast, agency conflict in concentrated firms is between controlling owners and minority shareholders. In such cases, the intention of the governance mechanism is to prevent expropriation by controlling owners. However, the ownership structure may limit the effectiveness of corporate control, as it determines the distribution of control, and accordingly the power of contracting parties within an organisation (Lannoo, 1999).

In a dispersed firm, minority investors do not have an incentive to monitor management individually because they bear the cost of monitoring and reap only a small fraction of its benefit (Shleifer & Vishny, 1997). If all small owners behave in the same way, monitoring tends to be weak in such firms unless another substitute mechanism exists. Given the free-rider problem, Shleifer and Vishny (1986) propose the presence of large shareholders as a governance mechanism in order to prevent management from pursuing opportunistic action. Given their significant ownership share, it is argued that large shareholders will pursue monitoring since they will reap substantial benefit from this action. Therefore, the role of large shareholders in monitoring management is a response to the free-rider problem associated with dispersed ownership.

Maug (1998) argues that monitoring by large shareholders is also associated with the capital gain because of their private information from monitoring actions. It is suggested that such benefit is theoretically supported since the trade-off between liquidity and control does not exist. Moreover, a blockholder is able to exercise voice strategy in order to protect their interest because they have a significant shareholding, which provides them with the power to vote against management actions. Accordingly, the power of a blockholder facilitates disciplinary action and provides the condition necessary for effective corporate governance (Smith & Walter, 2006). Empirical work claims that the presence of a blockholder may mitigate the agency problem as this type of owner has the incentive to monitor and the power to discipline management (Clyde, 1997; Jiambalvo, Rajgopal & Venkatachalam, 2002; Jones, Lee & Tompkins, 1997).

According to La Porta et al. (1999, 2000), a particular level of stockholding provides the large shareholder with almost complete control over the firm's decisions. This ownership structure determines the incentive and power of the large shareholder to commit expropriation from the firm. As documented by several studies, most of the firms around the world generally have controlling ownership, which is entrenched and sufficiently powerful to design the contract (La Porta et al., 1999; 2000). Having control of a firm, an owner can divert firm's resources where this diversion can take various forms such as salary, transfer pricing, and non-arm length transaction.

Theoretically, the disadvantage of single controlling ownership could be mitigated by certain ownership patterns. Maury and Pajuste (2005) argue that the most important dimension of control associated with majority shareholders rests in its contestability, which requires the presence of multiple large shareholders. A higher contestability associated with the existence of multiple blockholders increases the marginal cost of stealing, which lessens the incentive of expropriation and therefore enhances firm performance. However, the contestability becomes lower if a coalition consists of blockholders with greater voting rights and lower cash flow rights. They suggest that a higher wedge between voting and cash flow rights will lead to a decrease in the marginal cost of stealing. Nevertheless, it is suggested that contestability potentially improves the

alignment of interests of those contracting parties, implying that the benefit of a check and balance system would be achieved whenever control of the firm is optimally distributed among contracting parties²⁶. This perspective underlines the importance of unrelated blockholders, who have incentives to collect information and monitor management, and sufficient voting power to over-ride or oust management, as a governance mechanism.

However, the role of the large shareholder as a governance mechanism depends on the institutional setting in which the firm operates. The work of Dyck and Zingales (2004) reveals that concentrated ownership is positively related to the private benefits of control in the less developed capital markets while Haniffa and Hudaib (2006) find a negative relationship between the proportion of shares held by the five largest shareholders and firm performance in Malaysian firms. These results are inconsistent with those from European firms, where the presence of blockholders is related to better firm performance, indicating that blockholders in Asian economies collude to divert profits from the firm, while in European countries, they play a monitoring role (Faccio, Lang & Young, 2001). Accordingly, it is argued that the presence of domestic blockholders by families in Asia exacerbate agency problem.

The role of the large shareholder as a governance mechanism also depends on the level of corporate governance of their country of origin. Doidge (2004) argues that developed countries like the US provide strong investor protection through various regulations and market mechanisms which, in turn, force firms to adopt sound corporate governance practices. This protection facilitates continuous scrutiny by shareholders (Doidge, Karolyi & Stulz, 2004) and, consequently, investing firms face performance pressure that ensures they monitor their foreign investment (Boardman, Shapiro & Vining, 1997). Accordingly, it is beneficial for the host economy to sell a fraction of a company to a foreign firm that has already operated in that country with good governance practice (La

²⁶ Based on the control distribution, Gompers, Ishii and Metrick (2003) differentiate between dictatorship-firm and democracy-firm. However, this classification is based on the shareholder right to contest management decisions provided by company by law and charter. The former refers to the firm where management has an effective control and the latter refer to the case where shareholders might effectively challenge management proposals.

Porta et al., 2000). This investment pattern is believed to bring about improvement in corporate governance of host firms, since investing firms will demand such improvement to secure their investment.

2.4.4.2. Majority Shareholders and Control-enhancing Mechanisms

The identity of owners is an important aspect of ownership structure as higher ownership by different types of shareholders has been documented as producing a different impact on the association between control of the firms and organizational outcome. In the work of Jiambalvo, Rajgopal and Venkatachalam (2002), the term ‘large owner’ refers to institutional shareholders, where their substantial ownership has been claimed as providing necessary incentive and economic rationale to collect information and monitor management. Eventually, such shareholders are expected to have a positive association with value-enhancing activities. For example, Dechow, Sloan and Sweeney (1996) argue that firms under investigation for manipulation of earnings have less outside blockholders, suggesting that better informed blockholders reduce the perceived benefit of managing accruals. Ultimately, a significant shareholding enables the institutional shareholder to oust poorly performing management, thus providing managers with incentive to perform better. In other work, the term ‘large shareholder’ refers to the family ownership that is prevalent in Asia, European, and Latin America (Lins, 2003). Khan (1999) posits that family-based control, especially in Asia, has been accepted as an indisputable fact. According to Nam (2001), such patterns of ownership might be attributed to the specific culture, wealth accumulation and entrenched interest, and investor protection provided by the legal system.

The prevalence of ownership concentration by the controlling family has been asserted as providing rational justification to use the family as the unit of analysis and accordingly has important implications for governance research. Although this approach lacks theoretical support, there is significant incidence of governance research taking this approach. Some studies investigate the level of ownership by controlling families and its association with firm performance (Baek, Kang & Park, 2004; Mitton, 2004). Others examine the association between ownership concentration by a controlling family

and firm performance in the presence of specific moderating factors (Bae, Kang & Kim, 2002).

The family control is further enhanced through pyramidal and crossholding ownerships²⁷ that are believed to affect the nature of the association between the governance mechanism and the organizational outcome (La Porta et al., 1998). According to Claessens et al. (2002) pyramidal and cross-holding ownership create the divergence between control rights and cash-flow rights. This deviation would lessen the incentive alignment effect as controlling owners hold fewer cash-flow rights, and at the same time boost the entrenchment effect as majority owners carry greater voting rights (Johnson et al., 2000; Joh, 2003). Morck and Yeung (2003) suggest that the deviations necessarily provide sufficient incentive to commit expropriation of minority shareholders and facilitate tunnelling activities detrimental to minority wealth²⁸. Accordingly, such patterns of ownership tend to exacerbate agency conflict between majority and minority shareholders. In this context, Khan (1999, p.15) argues that

“...serious problems can arise from the nature of the financial markets where there is information asymmetry between banks and borrowers and between equity issuers and purchasers. Thus, there could be a possible failure of the dominant owners under dominant family-based corporate governance system to appreciate the interests of minority shareholders”.

Aside from pyramidal and crossholding ownership, controlling family involvement in management teams and on the board of directors has been documented. However, studies elaborating upon such involvement are limited. These studies commonly start out with the research question as to whether the involvement of a controlling family on the

²⁷ In a similar spirit, ADB (2001) differentiates three strategies pursued by the family to control the firm. The first is direct family ownership, where the family directly owns a substantial portion of shares of firms and becomes the controlling shareholder. The second is indirect control via a base company where the family gain complete control of one or more strategic base companies that have substantial equity participation in the subsidiaries (simple pyramidal structure). The third is indirect control via complex shareholdings where the family controls the group's member companies through its own shareholdings, investments made by the base companies, holdings of a non-profit foundation, and subsidiaries' equity participation.

²⁸ Joh (2003) finds that independent firms outperformed firms affiliated with large business groups in Korea before the economic crisis. This finding thus implies supportive evidence for the tunnelling hypothesis, where business groups might serve as a tunnelling channel.

board and in management, empirically exists, and whether such involvement is related to the organizational outcome. Brunello, Graziano and Parigi (2003), Khanthavit et al. (2002), Nam (2004) and Lins (2003) investigate the controlling family involvement in management and confirm that controlling-family members occupy a significant proportion of top management positions. Consistent with this finding, Nam (2003, p. 32) suggests that, in most Asian countries, "...controlling owners are typically preoccupied with conducting the managerial function themselves".

As previously presented, the prevalence of family control provides a rationale to use the family as the unit of analysis. One implication of this approach is that family ownership includes shareholding by the family members and by parties considered to be under the influence of the family (Claessens et al., 2002)²⁹. In other words, the shareholding of a single family member is treated identically to the aggregate shareholdings of family members of the controlling owners. Given the substantial shareholding of their family, the family members of controlling owners serving in management and on the board are treated equally to the individual insider who owns a substantial shareholding in the firm. Accordingly, when the family members of controlling owners serve in management, the outcome may be the type of managerial ownership problem advanced by Morck, Shleifer & Vishny (1988).

Agency theory predicts that agency problems arise whenever the ownership of the production factor is separated from its control (Monks & Minow, 2004). In such cases, the agent is assumed to be a professional manager who is less likely to have a significant shareholding in the firm. In this circumstance, Jensen and Meckling (1976) argue that management do not bear any cost associated with perquisite taking when they own zero shareholding in the firm they manage. As such, the agent's wealth is less sensitive to organizational outcome and therefore provides the agent with the incentive to pursue actions to benefit themselves at the expense of principals. In contrast, if managers hold a fraction of ownership, perquisite taking will cost managers in terms of discounting their

²⁹ Claessens et al. (2002, p.2746) note that " We do not consider ownership by individual family members to be separate, and we use total ownership by each family group—defined as a group of people related by blood or marriage—as the unit of analysis".

shareholding value. Based on this argument, Jensen and Meckling (1976) argue that higher insider ownership potentially lessens management incentive to pursue self-interested action and therefore enhances the convergence of interests of agent and principal.

Despite its advantages, insider ownership has also been noted as having a negative effect on agents' behaviour. Fan and Wong (2002) and Seifert, Gonenc and Wright (2005) suggest that higher insider ownership leads to entrenchment problems as such ownership provides insiders with sufficient voting power to secure their position. The disadvantage of an entrenchment effect is grounded on the premise that a necessary condition for effective corporate governance is that badly performing managers may be replaced (Macey, 1997). In this circumstance, firm disciplinary mechanisms are unable to function to remove poorly performing managers whenever an entrenchment effect associated with higher insider ownership exists (Volpin, 2002). Previous study reveals that the association between CEO turnover and firm performance is negated by the presence of insider ownership (Gibson, 2003) as such insiders have excessive influence over the decision-making process (Campos, Newell & Wilson, 2002). This view is consistent with Nam (2003, p.2), who argues that "...the beneficial effect of large shareholders can be expected only when the management is separated from ownership, or when proper corporate governance mechanisms are in place and operating so that outside shareholders can effectively oversee corporate management".

Other studies examine the prevalence of such involvement on the board. For example, Khoo (2003) finds that about 85% of listed Malaysian companies had owner-managers and the post of CEO, chairman of the board or vice-chairman belonged to a member of the controlling family or a nominee. According to Yeh and Woidtke (2005), such involvement facilitates controlling owners transferring corporate resources to themselves, thereby expropriating the minority shareholders' wealth and curtailing firm performance. This view is grounded on the premise that family members share the same interests and act collectively (Wiwattanakantang, 2001; Urtiaga & Tribo, 2004; Villalonga & Amit, 2006). This framework implies that the interests of controlling-

family members serving on the board are assumed to be necessarily similar to the management, which acts solely for the controlling family (Morck & Yeung, 2003). Accordingly, the directors who are family members of controlling-owner could be seen as having similar attributes to insider directors and potentially negate the board independence of management and therefore compromise the monitoring role.

The negative effect of such involvement is confirmed by Yeh and Woidtke (2005), who find that family members serving on the board of a firm are associated with firm value discount. The same study also finds that corporate value is lower whenever members from the controlling family serve on the management team and that the insider dominated board structure is attributable to agency problems due to separation between control and cash flow rights. Consistent with this result, Yeh, Ko and Su (2003) find that when family members serve as directors or in top management positions, the potential damage of their expropriation on minority shareholders and corporate value will be higher. In similar vein, Ho and Wong (2001) find that the percentage of family members on the board is negatively related to the extent of voluntary disclosure, suggesting evidence supportive of an entrenchment hypothesis.

2.5. Conclusion

Agency literature suggests that incomplete contracts require governance mechanisms in order to alleviate agency problems related to the separation of ownership and control. Governance mechanisms consist of several devices and the board of directors is at the apex of internal mechanisms. Within this theory, the board is primarily assigned as a monitoring device in order to reduce self-interested agent behaviour. An effective monitoring role might be fulfilled whenever a board demonstrates independence of management and possesses sufficient information regarding its firm's operation. The ultimate outcome of effective monitoring by the board will be reflected in better firm performance.

Recent governance studies find that, in most economies, the ownership of the firm is concentrated in the hands of a few wealthy controlling families, suggesting that the

dispersed ownership becomes an irrelevant framework. In Indonesia, family control is further enhanced through the involvement of their family members on the board of directors and in management positions, which results in two competing effects. Nevertheless, ownership concentration provides a basis for rationalising the family as the unit of analysis. Following this approach, this dissertation argues that the family members of controlling owners serving on the board will have identical properties with those of insider directors. This argument implies that the substance of combined leadership might exist in the two-tier system, particularly whenever the controlling owner appoints their family members to serve as board chairperson. Accordingly, the board independence issues in a one-tier system, to some extent are also applicable to Indonesia with its two-tier system. A review of relevant empirical work will be presented in the next chapter.

Chapter 3: Empirical Studies on the Relationship between Board Composition and Firm Performance

3.1. Introduction

In the previous chapters, the underlying theory of board composition and its association with firm performance were discussed. It has been documented that agency theory predicts that board composition might affect firm performance as it enhances board monitoring effectiveness. This chapter discusses in depth the empirical studies investigating the association between board composition and organizational outcome. This chapter is intended, firstly, to document the existing empirical studies in this area, and secondly, to identify the research gap, which serves as a basis for rationalizing the significance of the study in the context of Indonesia. It begins with discussing the motivation and contribution of existing empirical research. The following sections present the organizational outcome indicators and the results of previous studies. The last section summarizes the discussion.

According to Zahra and Pearce II (1989), the attributes of the board determine its role and its effectiveness, and subsequently affect the relationship between board and firm performance. They posit that board attributes refer to its composition, characteristics, structure and process, and state that there is dynamic interaction between these attributes. However, their model reveals that composition is an exogenous attribute while characteristics, structure, and process are endogenously determined by composition attribute. This provides justification for the claim that the board composition is the most important attribute of the board institution.

3.2. Motivations and Contributions

Empirical work investigating board composition advances various rationales justifying the importance of the study. However, the main motivation remains unchanged: to empirically test the underlying theory concerning the association between board composition and the behaviour of contracting parties. It is assumed that such an association is reflected in the observable and significant relationship between board

composition and particular organization outcome (Hermalin & Weisbach, 2003). Accordingly, most of empirical work begins with research questions asking whether the different board size, leadership structure (either combined or separated), and the proportion of outside directors to total number of directors, lead to different decisions and presumably, produce different outcomes.

The objective of earlier studies, which mostly focus on US firms, is arguably simple: to examine directly the effect of certain board composition on firm value, where this effect is assumed to be straightforward³⁰. Recent empirical work commonly begins with the argument noting the shortcomings and the inconclusive finding of earlier studies. This argument, it is believed, would justify further investigation of the same theme in a different setting and using different methods. Thus, the scholarly *raison d'être* of these works is twofold. The first is to contribute to academic literature by seeking empirical confirmation of the underlying theory. The second is to challenge the generalisation of previous findings by verifying either its external or internal validity.

3.2.1. External Validity

External validity refers to the verification of a previous finding in a different setting using a similar method. Most empirical studies investigating board composition fall into this category. This stream of work argues that firms in different populations possess specific characteristics that might affect the relationship between board composition and firm outcome. The specific population might refer to the firm size, type of industry and growth opportunity.

As Daily and Dalton (1993) observe, studies researching board composition focus heavily on larger firms. They argue that firm size might confound such a relationship. Specifically, larger firms tend to be complex and face more internal and external forces, which reduce the ability of any given individual to initiate change, to affect the direction of the firm and to influence the organizational outcome. Consequently, the complexity of a large firm complicates the relationship between governance structures and

³⁰ See for example Daily and Dalton (1992) and Fosberg (1989).

organizational performance. By contrast, a small firm adopts simpler structures and systems, resulting in a more narrow focus, which makes it easier to direct and change the direction of a company. Thus, CEO and directors are less constrained by the organizational and structural system in small firms, and therefore more able to influence the outcome of the firms. This implies that the effect of board composition on firm performance is more likely to be observable in small firms.

Barnhart, Marr and Rosenstein (1994) contend that firm performance varies systematically across industries. This indicates that industry characteristics may confound the association between board composition and firm performance. Accordingly, studies addressing this issue should account for industry effect. Based on this argument, Judge (1994) argues that focusing on a single industry sufficiently justifies the importance of the study as an intra-industry comparison is more meaningful than a between-industry comparison.

The association between board composition and firm performance might also be affected by the presence of incremental agency conflict embedded in the growth opportunity (Hutchinson & Gull, 2004). The motivation for a study focusing on this issue is grounded on the premise that investment opportunity sets may exacerbate agency conflict due to the higher information asymmetry problem. Growth options, unlike assets-in-place, are discretionary investment opportunities specific to the firm, which require specific control mechanisms in order to be pursued. Therefore, the optimal board for a growth firm might require a composition different from those of a non-growth firm. Boone et al. (2007)) argue that a growth firm emphasizes the board advisory role, rather than the monitoring role, and this focus may complicate the association between board composition and firm performance.

The non-US based studies commonly begin with similar underlying presumptions. This work presumes that an environmental setting can potentially affect internal governance structure and its effectiveness. According to Vafeas and Theodorou (1998, p.384), "...while the assumption of a utility-maximizing agent is universal, each country's

regulatory and economic environment, the strength of capital markets, and current governance practices are different” and therefore the US results regarding the board structure-performance relationship may not be generalized. Accordingly, they suggest that the importance and value of various governance structures should be separately examined in each country. This argument is consistent with an institutional perspective, which contends that, to some extent, the specific environment faced by the firm might have a substantial impact on the firm’s structure, governance, and its accomplishment.

The US institutional environment is commonly cited as characterized by strong legal protection³¹ (La Porta et al., 1999; 2000) which eventually leads to a large, deep and liquid market, active institutional investors, and a dispersed ownership (Erickson et al., 2005). This setting it is believed would enhance the simultaneous working of both internal and external governance mechanisms in reducing self-interest behaviour from agents (Brunello, Graziano & Parigi, 2003). The departure from the US setting potentially affects the effectiveness of corporate governance, in general, and internal mechanisms in particular. Consequently, the motivation for the study refers to the verification of the underlying theory in different institutional environments.

Park and Shin (2004) find that the differences between the Canadian institutional setting and that of the US hinge upon the ownership structure and the small number of institutional investors. Specifically, they contend that ownership of Canadian firms is concentrated in the hands of majority shareholders. This setting implies the existence of illiquid markets that force the institutional investor to actively monitor management as the market provides less liquidity to pursue an exit strategy. In such an environment, institutional investors would make demands for board representation in order to secure their investment. They argue that the directors representing institutional investors would result in a different impact on the relationship between board composition and firm performance as compared to those representing non-institutional shareholders.

³¹ Indeed, Denis and McConnell (2003) suggest that the legal system is believed to be the main feature of an institutional setting and that feature characterizes the so-called “second generation of corporate governance research”.

The difference in institutional setting between Australia and the US has been documented by Matolcsy, Stokes and Wright (2004) contending that the market is small in the Australian corporate governance system. This setting is less likely to encourage an active market for corporate control. Consequently, they argue that the effectiveness in "...inducing boards to be strict monitors and take corrective action in case of failure, may not be comparable to the US and the UK" (p. 2). Therefore, they believe that it is important to investigate the relationship between the board of directors and firm performance as it may help to "...differentiate between the role of market specific factors versus governance characteristics" (p.3).

Some European evidence has emerged, although the number of studies is limited. These studies commonly refer to ownership structure and financing patterns as the main differences in institutional settings between those of US and European countries. Traditionally, firms in the European Union are stakeholder oriented and are characterized by the a prevalence of insider dominated control and relational investment and the reliance on credit markets and less on equity markets that make ownership fairly concentrated and stable over time (Lehman & Weigand, 2000). This pattern of investment may mitigate agency problems as it enhances collective action by small owners and reduces information asymmetry.

A cross-country analysis of European-based firms by Krivogorsky (2006) suggests that management's objective is not necessarily to maximize stock prices, nor to be sensitive to firm performance within this environment. It is argued that although the law systems are quite distinct, the individual codes in a single country expresses relatively common views on issues related to the importance of board composition, ownership structure, and its influence on firm performance. However, Klapper and Love (2004) find that the effectiveness of investor protection provided by the legal system varies across European countries. This finding suggests that different institutional settings exist across this region. Thus, although a common view might prevail, the different levels of investor protection might lead to the inherent endogeneity problem of cross-country analysis as this study suffers from different institutional settings among European countries.

Analysis of a single, European-based country has also been documented, although the number is still limited. The Belgium evidence by Dehaene, De Vuyst and Ooghe (2001) starts with the description that this economy is characterized by ownership concentration, less active institutional investors, fewer listed firms and a higher level of majority shareholders' involvement in management decisions. Similarly, an Italian-based study reveals that its institutional setting is also typified by concentrated ownership, the absence of large independent shareholders and limited bank monitoring (Brunello, Graziano & Parigi, 2003). It is suggested that these features lessen the effectiveness of internal mechanisms to discipline poorly performing managers as the controlling shareholders dominate the board of directors and the management team. Postma et al. (1999) claim the lack of take-over mechanism and low investor protection in the Dutch institutional setting. According to Dehaene, De Vuyst and Ooghe (2001) the different business contexts between those of US and European countries might create distinct corporate governance and accordingly "...comparing US and UK models in isolation can lead to the futile conclusions" (p. 383).

The Asian-based work commonly starts with the similar presumption to those of European-based studies. These studies are motivated by the importance of verifying the findings of developed countries in different business contexts. However, unlike their European counterparts, the agency problem of Asian firms is exacerbated by the existence of coalitions between controlling shareholders and blockholders (Faccio, Lang & Young, 2001), excessive control by majority owners, and heavy reliance on external financing (ADB, 2000). Furthermore, La Porta et al. (2002) suggest that most Asian economies exhibit lower degrees of investor protection.

The Malaysian evidence by Haniffa and Hudaib (2006) reveals that that economy has different institutional settings to those of the US. First, ownership of the firm is highly concentrated, where the majority control is further enhanced through pyramidal and cross-holding ownership. This implies the absence of a corporate market for corporate control and hence leaving minority shareholders without protection except through adopting an exit strategy, which is a weak defence against management control.

Secondly, the higher degree of owners' involvement in management decisions suggests the absence of separation of ownership and control and increases the likelihood of expropriation from minority shareholders. Thirdly, the lack of a merit system in the lending process, as a result of a close relationship between firms, bank and government, encourages morally hazardous lending practices. Similarly, Yeh, Ko and Su (2003) posit that the specific institutional setting of Taiwan hinges upon the prevalence of ownership concentration, low institutional ownership, an inactive market for corporate control and less investor protection provided by the legal system. These institutional features thus provide majority investors with higher degrees of control. Accordingly, they contend that the relationship between board composition and firm performance of Asian firms might demonstrate different patterns from those in the US and UK.

Change in an economic system, as a result of political change, has been identified as providing sufficient rationale to support the importance of a study. An economic system, in general, can be broadly categorized as either being derived from capitalism or socialism. The political system change in Russia, which led to the switching of the economic systems from socialism to capitalism, has been argued as having an impact on corporate governance demand (Peng, Buck & Filatotchev, 2003). This switching triggered mass privatization of former state-owned enterprises that then created a demand for corporate governance. Given the earlier stage of market development, the internal governance mechanisms might produce different outcomes as compared to developed countries. However, governance reform might produce performance improvement as the new directors have less political connection with former communist regimes. Based on these arguments, Peng, Buck and Filatotchev (2003) contend that investigating Russian firms after mass privatization significantly contributes to the governance literature.

3.2.2. Internal Validity

Complementing external validity, several studies have challenged the findings of previous research by using different approaches. This so-called internal construct validity covers broader aspects of empirical methodology such as measurement,

definition of variables, linearity, interdependence, and endogeneity issues. Internal validity is also related to the approach capturing the outcome of board monitoring effectiveness (Bhagat & Black, 2002). Indeed, this stream of work might propose the different prediction as a result of a different underlying theory of empirical analysis. The following section presents further discussion of the internal validity of empirical work.

3.2.2.1. Theoretical Background

A study investigating the relationship between board composition and organizational outcome might adopt one of many existing underlying theories (Zahra & Pearce, 1989). According to Hung (1998), a theory reflects the argument of a different school of thought that proposes a different role and, accordingly, a different prediction regarding the effect of board composition on firm performance. Specifically, the association between board composition and organizational outcome could be analysed using resources dependence theory, class hegemony theory, a legalistic approach, stewardship theory and agency theory (Zahra & Pearce, 1989; Hung, 1998).

Resources dependence theory emphasizes the advice and service role, where the board is responsible for providing information to the executives and for securing the vital resources (Pfeffer, 1972). This view implies that such roles are best performed by interlocking directors that increase coordination, reduce transaction costs, and improve access to the resources and information (Provan, 1980; Pearce II & Zahra, 1992). Class hegemony theory argues that the boards serve as a device of elite capitalists to consolidate and maintain their power in order to control social and economic institutions. Accordingly, the main responsibility of the board is to create inter-organizational relationships in order to ensure the sustainability of the firm. Within this view, only individuals of the ruling elite class may serve as directors and the exclusivity of this structure provides assurance that the interest of the elites are protected (Ratcliff, 1980). Zahra and Pearce (1989) posit that empirical studies borrowing the resources dependence and class hegemony theories are limited.

Agency theory views the board as an ultimate mechanism of internal corporate control. This theory assumes that managers are self-interested individuals and therefore the main role of the board is to monitor management in order to ensure that the interest of shareholders is well respected. Unlike the agency framework, stewardship theory assumes that the individual is trustworthy rather than self-serving (Davis, Schoorman & Donaldson, 1997). This implies that managers are good *stewards* of the corporation, and therefore the steward and principal might establish mutual cooperation and a “goal alignment”. Consequently, stewardship theorists believe that managers will perform better whenever they are trusted and granted decision-making authority. In this framework, a governance structure will be optimal if it permits coordination between board and management (Donaldson, 1990; Donaldson & Davis, 1991) as the board is expected to focus on their advisory role.

The legalistic approach posits that boards contribute to firm performance by performing their mandated responsibility, where the directors are entitled to the legal power to fulfil their responsibility. This approach is intended to obtain empirical confirmation regarding the impact of specific legal provisions on the association between the board composition and organizational outcome. It is asserted that the regulations imposing minimum inclusion of independent directors were pioneered by Cadbury Report of UK (Dahya & McConnel, 2005), which is derived from the perspective of agency theory (Hung, 1998) and accordingly, the theoretical background and the prediction of the relationship between board composition and firm performance is similar to that of agency theory. An example of this study is found in Hossain, Prevost and Rao (2001) of New Zealand investigating the effect of the Company Act 1993 on the association between board composition and firm performance while similar work from Spain has been documented by Anson and Rodríguez (2001).

Zahra and Pearce II (1989) observe that most empirical studies use agency theory as their conceptual framework. However, some empirical works have simultaneously borrowed agency theory and stewardship theory. Empirically, such theories have been quoted as having two competing predictions in relation to the effect of board

composition on firm performance. According to Desai, Kroll and Wright (2003), stewardship theory predicts that the proportion of independent directors serving on the boards has a negative association with market return, while under agency theory the proportion of independent directors is expected to have a positive association with such a return. Tian and Lau (2001) test these hypotheses using accounting earnings as performance indicators.

3.2.2.2. Interdependence among Governance Mechanisms

An important issue pertinent to the association between board composition and firm value is the interdependence between governance mechanisms (Agrawal & Knoeber, 1996). According to Berglöf (1997), interdependence refers to the substitutability and complementary relationships among governance mechanisms³². The work of Heinrich (1999) provides a rationale for the coexistence of different configurations of corporate governance as the consequence of the multitude of agency problems, which may produce equal outcomes. Consequently, a firm may choose a certain governance configuration across the mechanism or within the mechanism that most effectively meets its organizational and environmental context (Du & Dei, 2002). In support of this notion, Danielson and Karpoff (1998) find that governance mechanisms vary across firms without any uniform pattern, suggesting that firms adopt certain governance combinations that best address their specific issues. However, specific combinations of instruments “...which reinforce each other in minimizing agency costs fit together better than alternative combinations” (Heinrich, 1999, p.2).

The substitution argument posits that the importance of a particular monitoring device depends on the presence of multiplicity of control mechanisms while the complementarities argument suggests that the effectiveness of the board monitoring role is contingent upon the presence of other strong governance mechanisms (Rediker & Seth, 1995). A number of studies investigating the association between board composition and firm performance have addressed the substitutability issue among

³² Other studies use contingency perspective as a synonym term to the interdependence framework. See for example Beatty and Zajac (1994) and Kang and Zardkoohi (2005).

governance instruments and supported the existence of substitution effects among governance variables. Coles and Hesterly (2000) find that board independence becomes a significant negative predictor of organization outcome when there is interaction between board and leadership. This result suggests that the market views insider directors positively when the board chairperson is independent of management for the reason that insider directors provide information necessary to make effective decision making.

In a broader coverage of governance mechanisms, the work of Rediker and Seth (1995) implies that the importance of the board as a monitoring device depends on the presence of a multiplicity of control mechanisms. Berry, Fields and Wilkins (2006) examine the interdependence between the proportion of independent directors, insider ownership, large shareholder, and directors representing venture-capital firms. They find that independent directors have a negative association with venture-capitalist directors, suggesting that independent directors were added to compensate for venture capitalist directors in order to maintain board independence. This study provides supportive evidence that as higher agency costs occur due to decrease in insider ownership, other mechanisms such as independent directors, venture-capitalist directors, and unaffiliated blockholdings change in ways that help to mitigate agency problems. Zajac and Westphal (1994) report that CEO incentives (equity holding) are negatively related to the level of board monitoring as represented by the proportion of independent directors and separated leadership. They suggest that this finding supports the view that monitoring by boards is less important when the incentive structure is strong.

The complementary relationship among governance mechanisms has been documented by agency studies. Methodologically, these studies commonly rely on the cumulative score of a particular governance index as a construct of governance level, where a higher score is believed to have better governance arrangements. This approach assumes that governance mechanisms complement each other and these complementarities are reflected in the higher cumulative scores. Based on this proposition, some studies have used a governance composite index. Durnev and Kim (2005) and Mitton (2004) use a

governance index of CLSA, which incorporates governance mechanisms and provisions. Brown and Caylor (2004) borrow a governance index developed by International Shareholders Service, namely Corporate Governance Quotient (CGQ), consisting of four aspects such as board composition, compensation, takeover defences, and auditing. Others have constructed particular governance indices that suit the specific objective of the study. Gompers, Ishii and Metrick (2003) construct a governance index focusing on the provisions that potentially reduce shareholder rights, consisting of five major items such as tactics for delaying hostile bidding, voting rights and their mechanisms, director/officer protection, state laws, and other takeover defences. Black, Jang and Kim (2006) and Bai et al. (2004) use a specific index incorporating governance mechanisms and particular provisions.

Coles and Hesterly (2000) believe that most empirical studies ignore the interdependence issue as such studies partially examine the single subset of governance mechanism in an isolated relationship. This might contribute to the spurious findings and inconsistent estimator of regression analysis that complicates the interpretation and generalisation of the results (Agrawal & Knoeber, 1996). Accordingly, studies investigating the relationship between board composition and firm performance should control for the presence of other governance mechanisms available within a specific institutional context. Nevertheless, the literature is inconclusive as to whether the relationships between governance mechanisms are complementary to, or substitutes for, each other³³.

3.2.2.3. Linearity

Generally, directors can be characterized as either insider or outsider (Dalton et al., 1998). The standard view of agency theory posits that outsider directors represent independence of management, but can be impaired by receiving incomplete information regarding firm operation, while insiders are well informed, although their independency from management may be compromised (Rhoades, Rechner & Sundaramurthy, 2000). Therefore, the board potentially lessens the conflict between manager and shareholder if

³³ See for examples, Rediker and Seth (1995) and Agrawal & Knoeber (1996).

the directors are independent of management and have sufficient knowledge of the firm (Ward, 2003). In support of this notion, Green (2005) suggests that the board would optimally monitor management whenever there is a balance between independence and information properties. In this circumstance, the presence of insiders serving on the board potentially mitigates the information problem, while outside directors encourage an objective assessment of management performance. Accordingly, an optimal board composition comprises insiders and outsiders who bring different attributes, skills and knowledge to the board (Bhagat & Black, 2002).

Given that the optimal board comprise a balance of insider and outsider directors, Block (1999) argues that there exists an optimum point of inclusion of outsider directors serving on the board. Particularly, adding outside directors to the board is beneficial whenever the optimum point has not been reached. This inclusion will encourage board independence and therefore promote the effectiveness of its monitoring role. Eventually, higher board independence enhances the convergence of interest between those of principal and agent, which leads to better firm performance. After the optimal level has been achieved, the incremental benefit of having additional outsiders on the board will diminish due to the information asymmetry problem. This argument implies that there exists a non-linear relationship between both insider and outsider directors and firm value.

A study by Barnhart, Marr and Rosenstein (1994) incorporates this issue and employs quadratic and cubic terms in overcoming such issue. Their work reveals that firm performance is related to outside director in quadratic terms and in cubic terms, suggesting that the relationship is non-linear. Moreover, a polynomial shape is found in the relationship between outside director and firm performance, suggesting that firm performance tends to fall as outside directors increase, but then rises after outsider directors constitute approximately two-thirds of the board. Instrumental variables analysis also reveals that the representation of outside director has a curvilinear relationship with performance. Baysinger and Butler (1985) confirm that the relationship between board composition and relative financial performance is not strictly linear with

some forms of diminishing marginal return when adding independent directors to the board. To capture the non-linearity relationship, they divide the independent director representation into discrete categories based on those above and below average. They argue that such grouping reflects the sharp differences in board staffing philosophies. In similar vein, Block (1999) decomposes the sample into deciles groups and finds that the pattern of such a relationship clearly yields a non-monotonic relationship.

The departure from optimal composition has been quoted as the source of boards' failure to effectively pursue their roles. Bhagat and Black (2002) suggest that the trend towards a greater proportion of independent directors on boards is evident in the US. Their work reveals that between 1970 and the late 1990s, the US witnessed a switch from insider-dominated to outsider-dominated boards. The switching became dramatic after 1990, when significant numbers of corporations had a supermajority of outside directors on their boards. However, a supermajority of independent directors emphasizing the monitoring role might have a perverse effect (Baysinger, Kosnik & Turk, 1991). Due to the threat of disciplinary actions by outside directors, managers may become risk-averse, which forces them to reduce time horizons, change risk preferences, and limit the sensitivity of their wealth to the outcome. These factors tend to discourage managers from pursuing riskier projects with potentially positive returns.

Although potentially non-linearity problems might prevail, several studies continue to adopt linear relationship approaches without sufficient procedures to control for such problems. Examples of this approach are found in the work of Vafeas and Theodorou (1998) and Vafeas (2000). They investigate the boards of UK firms and fail to support an unconditional empirical link between board structures (the proportion of outside directors and leadership structure) and organisational outcome³⁴. Similarly, Judge, Naoumova and Koutzevol (2003) examine Russian firms and also fail to support the association between insider directors and firm performance.

³⁴ However, they control for the non-linearity relationship between ownership and firm performance.

3.2.2.4. Endogeneity

An important issue pertinent to the association between governance mechanisms and firm performance is the endogeneity problem that has been quoted as a major concern for firm-level variables (Black, Jang & Kim, 2004; 2006). Endogeneity refers to the direction of causality on the relationship between governance and firm performance that inherently plagues empirical governance studies (Drobetz, 2003). Such issues potentially confound the interpretation of research findings as the governance improvement might enhance firm performance although, in reverse, firms might improve particular governance mechanisms in response to poor prior firm performance (Börsch-Supan & Köke, 2002). For example, Rosenstein and Wyatt (1990) find that the appointment of additional independent directors has a positive relationship with firm performance, and they interpret this finding as supporting evidence that governance improvement encourages firm performance.

However, Hermalin and Weisbach (1998) claim that the probability of independent directors being added to the board rises following poor firm performance. They argue that governance mechanisms could be considered as a response to the prior poor performance in order to convince the market that the firms have adopted new strategies to overcome such performance problems. Within this context, empirical cross-sectional analysis may reveal that firms with a higher proportion of independent directors demonstrate lower performance and, consequently, independent directors will be interpreted as having a negative effect on the firm performance. This finding suggests that prior poor performance might drive outsider representation on the board. Conversely, the work of Yeh and Woidtke (2005) reveals that an insider-dominated board is negatively related to prior performance. They argue that this pattern indicates that majority owners pursue the entrenchment strategy to reduce the board monitoring role in order to retain their control of the firm.

In a broader perspective, Demsetz and Lehn (1985) argue that endogeneity is also related to the optimal differences of governance portfolio, suggesting that firms may endogenously and optimally choose different governance practices that best suit their

specific challenge. This so-called reverse causation also implies that more profitable firms may choose weaker governance as they have less need for outside capital (Black, Jang & Kim, 2004). By contrast, Nowland (2008) contends that a particular governance improvement depends on the resources available to the firm implying that better prior performance is associated with better corporate governance. Although producing conflicting results, these studies indicate the existence of the association between prior performance and the existing board composition.

Governance-performance studies have taken different routes in controlling for endogeneity problems. Lemmon and Lins (2003) propose an approach to addressing endogeneity concerns by examining changes in the variables of interest rather than their level. Similarly, Nowland (2008) uses panel data to relate changes in board measures to changes in firm performance. He argues that such an approach provides a direct test as to whether improvements in board-related governance mechanisms are associated with better performance and therefore inherently control for unidentified firm-specific variables. Dherment-Ferere and Renneboog (2000) use lagged data for independent and dependent variables while Durnev and Kim (2005) measure the dependent variables using an estimate of projected need for outside capital rather than an outcome-based measure.

According to Seifert, Gonenc and Wright (2005), if a governance variable is endogenously determined, the OLS estimation will produce biased results while two step least squares (2SLS) will result in better estimates of the relationship between a governance variable and performance. They posit that 2SLS involves identifying instrument variables that are correlated with the key independent variable and uncorrelated with the dependent variables. Examples of this approach are found in the work of Himmelberg, Hubbard and Palia (1999), Lehman and Weigand (2000), and Black, Jang and Kim (2004; 2006). The 2 SLS model adopted by empirical research is consistent with Börsch-Supan and Koke (2002) who suggest that a structured model might mitigate the endogeneity problem.

Although the structured model has been widely adopted, there is a lack of empirical consensus and theoretical support in identifying the determinants of particular governance mechanisms. Accordingly, empirical studies have proposed different models concerning the determinant of particular mechanisms³⁵ that exacerbate the difficulties in identifying independent and instrument variables. Moreover, the complementarities and substitution relationships between governance instruments imply that all of the governance variables are related to organizational outcome. As governance studies focus on the effect of particular mechanisms on firm performance, consequently, adopting a simultaneous equations approach to resolving the endogeneity is difficult to implement, "...because most instrumental variable candidates have been used as determinants in the regressions" (Fahlenbrach, 2003, p.24). Consequently, the effectiveness of a simultaneous model in resolving such a problem is questioned although such a model is econometrically robust (Coles, Lemmon & Meschke, 2007).

3.3. Outcome Approach

Agency theory posits that the main role of the board is to monitor management in order to prevent management from pursuing self-interest actions (Baiman, 1990). Jensen (1993) suggests that the effectiveness of a board's monitoring role depends on the level of board independence from management where such independence is determined by the leadership structure and the representation of outsider directors. As an effective monitoring device potentially enhancing firm performance, empirical studies follow the assumption that the effect of separated leadership and a higher proportion of outsider directors will be reflected in a better outcome achieved by the firm.

However, empirical studies have documented the absence of consensus regarding the most suitable indicator measuring organizational outcome. Indeed, there are two approaches to studying the effect of board composition on organizational outcome. The first approach examines the effectiveness of the board monitoring role in the specific event that potentially affects shareholders' wealth. The second approach directly investigates the effect of board composition on the overall firm value.

³⁵ See for example Mak & Li (2000, 2001), Rediker & Seth (1995), Bathala & Rao (1995)

3.3.1. Specific Task

Governance studies have investigated the monitoring role of the board using the discrete approach. This approach involves the board decision of a particular task to capture the outcome of monitoring effectiveness by the boards of directors. The advantage of this approach is it uses tractable data of the outcome, which makes it easier for the researcher to find statistically significant results (Bhagat & Black, 2002) and hence is potentially more powerful because it is less prone to unobservable factors contaminating the statistical relationship and is less likely to experience endogeneity problems (Hermalin and Weisbach, 2003). However, the discrete approach "...does not tell us how board composition affects overall firm performance" (Bhagat & Black, 2002, p.235). A discrete approach mostly refers to a specific task such as CEO turnover, management compensation, and takeover defence (McColgan, 2001). This approach commonly starts out with the proposition that different board composition reflect different levels of the monitoring role that lead to different outcomes of specific tasks.

The CEO turnover refers to the sensitivity of management turnover to prior poor performance. Studies addressing such issues posit that corporate governance is intended to enhance the interest alignment between those of management and shareholders by removing poorly performing managers. According to Jensen and Ruback (1983), the threat of termination might discipline managers whenever there is high probability that managers are more likely to leave their firms following poor prior performance. Subsequently, if there is a threat of dismissal, a CEO is assumed to take "...this threat into account when deciding how to run the firm" (Lausten, 2002, p.395). Thus, the threat of removal is expected to improve the alignment of interest of management and shareholders as it potentially reduces opportunistic behaviour by managers.

Some studies have investigated the effect of independent director representation on the sensitivity of poor performance to CEO turnover. They commonly start with the assumption that the task to monitor and replace poorly performing managers is likely to fall mainly on the outside directors as they have an incentive to build the firm's human capital reputation as a decision control expert (Weisbach, 1988). Accordingly, it is

predicted that the stronger relationship between poor performance and the probability of a CEO being replaced would be observed in the outsider-dominated and separated leadership board³⁶.

Executive compensation refers to the level of compensation and its sensitivity to performance. Within agency research, board composition has been quoted as having an impact on compensation schemes. This proposition is grounded on the premise that self-interest agents prefer to maximize their wealth in regard to the compensation where its success depends on the ability to reduce the board's monitoring role. As the monitoring role is determined by board independence, it is expected that different levels of outsider director representation and leadership structure will affect executive compensation schemes. Specifically, agency research predicts that lower levels of CEO compensation and pay-performance contracts would be more likely to be observed in the firm with higher fractions of outsider directors and separated leadership. Conyon and Peck (1998) find that in UK firms the link between pay-performance is more sensitive with outsider-dominated boards, while the work of Ryan and Wiggins III (2004) documents that amongst US firms, equity-based pay is less likely to be found in the firm with higher proportions of insider directors. Core, Holthausen and Larcker (1999) and Boyd (1994) find that CEO compensation is positively related to CEO duality, while Conyon and Peck (1998) fail to support such a relationship.

Takeover defence refers to the adoption of a particular provision, which provides a target firm with certain tactics to prevent a potential bid including greenmail, golden parachutes, and poison pills. Brickley, Coles and Terry (1994) suggest that different board composition might produce different outcomes with regards to the adoption of takeover defences. On the one side, some firms might use such provision to defeat offers and to create managerial entrenchment if the board is controlled by management. This view hinges upon the proposition that takeover is an important external governance as the changes in ownership are associated with the subsequent management turnover (Crespi-Cladera & Renneboog, 2003; Koke, 2004). Thus, takeover could be viewed as a

³⁶ See for example Goyal & Park (2002) and Lausten (2002).

turnover threat to the manager and takeover defence potentially related to an attempt to entrench management. Accordingly, the adoption of takeover defence provisions is more likely to be observed in a firm with a less independent board. Empirical work of Sundaramurthy (1996) confirms such a prediction and documents that the percentage of outsider directors loyal to the CEO is positively related to the adoption of anti-takeover provisions. Mallette and Fowler (1992) find that combined leadership is positively associated with the adoption of a poison pill.

In contrast, other firms might adopt takeover defences in order to benefit shareholders. Under a shareholder-interest view, such provision is intended to extract the highest possible price from the bidder in a control contest. Brickley, Coles and Terry (1994) argue that this benefit might be achieved if the board demonstrates sufficient independence of management in representing shareholder interests. They find that the average stock-price reaction to the announcement of the adoption of a poison pill is positively significant when outside directors comprise a majority of the board and negatively significant when they do not.

Complementary to the CEO turnover, management compensation and takeover defence, some studies propose the use of particular indicators of organizational outcome. These studies argue that the effectiveness of a board monitoring role might be reflected in the different firm's achievements. Baysinger, Kosnik and Turk (1991) address this issue by using average R&D spending per employee as the proxy of organizational outcome. Berry (2006) takes a different route by employing the state of the firm 11 years after an IPO, where firms are classified as either being survive, acquired, or bankrupt. Judge Jr. (1994) constructs social performance composite measures consisting of charity care, Medicaid revenue, and bad debts to total revenue. They claim that adopting specific outcomes significantly contribute to the theoretical developments. As Judge Jr. (1994) argues, the use of specific outcomes is intended to develop a more integrative perspective on organizational effectiveness.

3.3.2. Financial-based Performance

Complementary to the discrete approach, some studies investigate the direct effect of board composition on the overall firm performance. In this regard, the overall firm performance is measured using financial-based indicators. This approach allows the researcher to directly examine the bottom line of agency theory, which posits that board composition matters in predicting firm performance as it reduces perquisite taking by an agent. According to Bhagat and Black (2002), the main disadvantage of this approach lays in the use of less tractable data on the outcome. Therefore, they suggest that the firm performance, as the outcome of board monitoring, should be addressed carefully.

The indicators of the overall firm performance used by empirical research vary across studies. However, these indicators could be broadly categorized as either being “accounting-based” or “market-based”. Accounting-based generally refers to the audited accounting information, while market-based relies on firms’ share prices, which serve as a direct proxy for shareholders’ wealth. Rhoades, Rechner and Sundaramurthy (2000) observe that studies investigating the relationship between board composition and firm performance mostly utilize six financial indicators such as Return on Asset (ROA), Return on Equity (ROE), Earning per Share (EPS), profit margin, market value of share, and market to book value.

Some studies use market-based indicators as the proxy for firm performance. Barnhart et al. (1994) and Vafeas and Theodorou (1998) use market to book value while Lawrence and Stapledon (1999), Postma et al. (1999), Rosenstein and Wyatt (1997) utilize market return. However, these indicators have been modified variously across studies. For example, Bhagat and Black (2002) use industry adjusted market return, while Lawrence and Stapledon (1999) use cumulative abnormal return. Other studies select accounting-based indicators measuring firm performance. Lehman and Weigand (2000) employ ROA, while Hutchinson and Gull (2004) choose ROE as performance indicators. Dehaene, De Vuyst and Ooghe (2001) use ROE and ROA, while Tian and Lau (2001) and Schellenger, Wood and Tashakori (1989) adopt both accounting and market-based measures as performance indicators.

Nevertheless, the various measures indicate that empirical work experiences a lack of consensus regarding the most suitable measure of firm performance. Indeed, the work of Rhoades, Rechner and Sundaramurthy (2000) reveals that the empirical relationship between board composition and firm performance is sensitive to the operational definition of performance. Given this sensitivity issue, accordingly, empirical work commonly adopts various performance indicators in order to test the robustness of the results.

3.4. Results

Empirical works investigating the relationship between the proportion of insider/outside directors and firm performance have documented inconclusive findings (Appendix 1). A positive relationship is found in Dehaene, De Vuyst and Ooghe (2001), Hossain, Prevost and Rao (2001), Hutchinson and Gull (2004) and Krivogorsky (2006). Other studies present a positive relationship between the proportion of insider directors and firm performance (Kesner, 1987), a negative relationship between the proportion of outsider directors and firm performance (Lawrence & Stapledon, 1999; Bhagat & Black, 2002; Del Guercio, Dann & Partch, 2003; Erickson et al., 2005) while an insignificant relationships have been documented by Fosberg (1989), Hermalin and Weisbach (1991), Peng, Buck and Filatotchev (2003) and Tian and Lau (2001)³⁷. Moreover, the inconclusive findings are also found in a single study. For example, Vafeas and Theodorou (1998) find that the fraction of non-executive directors is insignificantly related to firm performance in OLS result, while 2SLS reveals a negative relationship. The work of Schellenger, Wood and Tashakori (1989) documents a positive relationship with market return and an insignificant relationship with accounting performance.

The inconclusive finding is also found in the empirical work addressing the issue of the relationship between leadership structure and firm performance (Appendix 2). Some studies present empirical support of a positive relationship between an independent

³⁷ Rosenthal (1979) suggests the likelihood of a tendency in empirical research to publish studies that find statistically significant effects only. This so-called “file-drawer problem” implies that studies producing insignificant relationships mostly remain unpublished.

leadership and firm performance (Faccio & Lasfer, 2000; Coles, McWilliams & Sen, 2001; Desai, Kroll & Wright, 2003; Carapeto, Lasfer & Machera, 2005) and a positive association between combined leadership and organizational outcome (Davidson, Worrell & Cheng, 1990; Tian & Lau, 2001). A negative relationship is found in the work of Rechner and Dalton (1991) while an insignificant relationship is presented by Daily and Dalton (1993, 1995), Schmid and Zimmermann (2008), Brickley, Coles and Jarrell (1997), Chen et al. (2006) and Fosberg and Nelson (1999).

3.5. Concluding Remark

Studies investigating the association between board composition and firm performance advanced external and internal validity motivations, providing academic rationale to further investigate such issues. The external validity refers to the verification of previous findings in different settings using similar methods. The motivations of US-based studies refer to the presumption that a firm in a particular population possesses specific characteristics, which might affect the relationship between board composition and that firm's outcome. The importance of non-US based studies hinge upon the presumption that the departure from the US institutional setting might affect the structure and effectiveness of firm level governance. Accordingly, the importance and value of various governance structures should be separately examined in each country. With regard to internal validity, there are three important methodological issues; namely endogeneity, interdependence, and linearity. The failure to adequately control for these issues is believed to lead to spurious results, which contributes to the inconclusive findings.

Although the inconclusive findings have been quoted as providing motivation to conduct a meta-analysis study, Hubbard, Vetter and Little (1998) argue that the systematic replication of research is more useful than a meta-analysis. This view is complementary to Cortina (2002) and Fuller and Hester (1999), who challenge the result of meta-analysis as a final finding. According to Kang and Zardkoohi (2005), a meta-analysis by Dalton et al. (1998) finds the potential for further moderating influences. Consequently,

a well-designed primary study replicating previous research remains necessarily required in the theory development³⁸.

The previous discussion reveals that research gaps exist in empirical studies investigating the association between board composition and firm performance. The first refers to the external validity, which suggests that replicating work in non-US settings is still needed. Secondly, such study is expected to address internal validity issues sufficiently in order to overcome the shortcomings of previous work. This implies that replicating such study focusing on the context of Indonesian settings might provide a significant contribution to the governance research whenever such study adequately controls for internal validity issues. The next chapter will provide the detail of Indonesian institutional settings and discusses the legal system, market for corporate control, ownership, and board of directors and management of Indonesian listed firms.

³⁸ In addition, Allen and Preiss (1993) suggest that replication and meta-analysis are complementary.

Chapter 4: The Institutional Setting of Indonesia

4.1. Introduction

In the previous chapters, theoretical and empirical work discussing the relationship between board composition and firm performance was presented. It was argued that board composition might affect organizational outcome and that the impact is contingent upon the presence of other governance mechanisms. This chapter elaborates the state of the institutional setting within Indonesia and its impact on firm-level governance. As such, the objective of this chapter is threefold. The first is to document the state of the institutional setting of Indonesia. A second objective is to identify the existing governance mechanisms available in Indonesia. A third objective is to provide a basis for rationalizing the impact of other governance mechanisms on the relationship between board composition and firm performance incorporated in the hypothesis development. This chapter begins with discussions of the legal system, the market for corporate control, and shareholders' rights as stipulated by the existing regulations. The following section will discuss corporate ownership and control and the board of directors. The last section will summarize the discussions.

An institutional setting has been referred to as the country-level governance that potentially affects the firm-level governance (Doidge, Karolyi & Stulz, 2007). A study by Stulz and Williamson (2003) indicates that corporate governance systems appear to differ systematically across economies as a consequence of different cultures. This view is consistent with Nam (2001) claiming that culture might determine the pattern of corporate control. In the works of La Porta et al. (1997, 1998) institutional setting refers to the investor protection provided by the legal system. Such a setting has been quoted as shaping the financing pattern, ownership structure and the effectiveness of firm-level governance (Lehman & Weigand, 2000).

4.2. Legal System

Indonesian legislation consists of various forms as a consequence of its categories and hierarchical sources (Tabalujan, 2005). Within the Indonesian legislation system, the

National Assembly (NA) is the supreme institution in the country and its legislative product is the NA decree³⁹. However, the decree commonly provides the general rule, such as the constitution and the judicial system, while the specific detail of a particular decree is stipulated in the Law (ratified by the President and House of Representatives) and/or the decrees of subordinate agencies. In 1999, subsequent to the crisis that erupted in 1998, the NA initiated a legal reform mandating the existing administration to reform the legal system in order to eliminate corruption, collusion, and nepotism⁴⁰. The assembly believed that such behaviour of misconduct prevented the corporate sector from exercising good corporate governance which became the main source of the economic crisis and political turbulence in late 1998. The legal reform included establishing good government and restructuring the legal system of the corporate sector in order to eliminate *crony capitalism* that relies on special privileges from political connection (ADB, 2001). As it was endorsed by the supreme institution in the Indonesian political structure, this decree provided the government with the strong legal foundation to reform the broader aspects of good governance.

According to path dependence theory, the existing practice of corporate governance is determined by the tradition where the particular economy begins (Bebchuk & Roe, 1999). Wibisono (1996) suggests that the initial phase of the Indonesian economy began with establishing state-owned enterprises through the nationalization of Dutch companies, where between 1600 and 1945 the Dutch occupied and established the East India colony, the former name of Indonesia (Brown, 2003). In the period of colonization, the Dutch government chartered the Dutch East India Company, which was fully responsible for governing the colony of Indonesia. Such colonization has been quoted as spreading the legal tradition (Gevurtz, 2004), suggesting that the colonial system established the source of the Indonesian legal system (Tabalujan, 2002). This implies that the Indonesian legal system and the governance structure imitate the Dutch system.

³⁹ In August 2000, the National Assembly endorsed the decree No: III/MPR/2000 concerning the official hierarchy of legislation (see Appendix 3).

⁴⁰ See Ketetapan MPR No.: IV/1999. The resignation of a powerful leader, General Suharto, provided Indonesia with the opportunity to conduct several improvements to its regulatory framework (Robertson-Snape, 1999) to potentially enhance good governance in the corporate sector.

La Porta et al. (2002) argue that the Dutch legal system follows the French civil law tradition, suggesting that the Indonesian judicial system originated from the French civil tradition. Such tradition has been identified as providing the court with little discretion in interpreting the duty of loyalty and the duty of responsibility (Johnson et al., 2000) and therefore being less adaptive to the changes in the business environment. Accordingly, the civil court is more likely to produce a decision in favour of the defendant in relation to a shareholder lawsuit towards directors' and managers' breaches of fiduciary duties (Johnson et al., 2000). Furthermore, Hoadley (2004) argues that such imitation creates an imperfect copy of European models due to the differences in culture and the prerequisite conditions. This is particularly relevant in Indonesia where the judicial system has proven ineffective in promoting law enforcements due to the lack of institutional support, political interference, and the corruption within the judiciary system (Lindsey, 2002; 2004).

As summarized in Table 1, several works have researched the quality of law and its enforcement and the specific regulation with regard to investor protection in Indonesia. Overall the table indicates that the Indonesian legal system is less protective of the financial supplier. The score of bankruptcy arrangement is 4.5 out of 8: the second worst among the countries studied, suggesting that investors and creditors will face severe difficulties in pursuing their rights (Claessens, Djankov & Klapper, 2003). Lower scores are also found in the anti-director and creditor rights (Claessens, Djankov & Nenova, 2000) implying higher uncertainty of investor and creditor claim resolution. Moreover, the score of creditor right is 0, suggesting that the legal system leaves the lender completely unprotected. The rule of law and enforcement also displays a lower score, suggesting that investor protection provided by the legal system is weak (Durnev & Kim, 2005). This finding is consistent with the work of Lindsey (2002) who argues that the court emphasizes 'rule-by-law' instead of 'rule-of-law' in Indonesia. The overall judicial system exhibits the poorest quality among economies around the world (Beck, Demirgüç-Kunt & Maksimovic, 2003) and among East Asian countries (Krishnamurti, Sevic & Sevic, 2005).

Table 1: Score of Investor Protection Provided by Legal System of Indonesia

Description	Score	Lowest Score	Highest Score
Anti director right ¹	2	0	5
Bankruptcy arrangement ²	4.5	0	8
Creditor right ²	0	0	4
Rule of law and enforcement ³	3.33	0	10
Overall judicial system ⁴	3.5	0	6

Sources:

- 1 Claessens, Djankov and Nenova (2000)
2. Claessens, Djankov and Klapper (2003)
3. Durnev and Kim (2005)
4. Beck, Demirgüç-Kunt & Maksimovic (2003)

In 1999, the office of Coordinating Ministry for Economics, Finance and Industry established the National Committee for Corporate Governance (NCCG)⁴¹ that is responsible for designing and promoting good corporate governance. The committee believes that sound corporate governance will provide companies with an advantage that is necessarily needed in the competitive environment. The committee has developed the Indonesian Code for Good Corporate Governance that is “...intended to be implemented as soon as possible...and serves as a guide to excellence in corporate governance for the business world” and for related agencies (National Committee for Corporate Governance, 2001, p.1). The committee posits that the code was derived from the international best practices, although adjustments have been made in order to promote the congruence between such practice and the Indonesian legal and regulatory environments. Such an assertion is confirmed by a study by the World Bank (2005) concluding that the Indonesian formal rules of corporate governance did not differ substantially from the OECD principles adopted by its member countries. However, the same study notes that “...corporate governance practices often fall short of the requirements of the OECD principles” (World Bank, 2005, p.2).

4.3. Market for Corporate Control

The ADB (2000) recommends East Asian countries reform industrial development policies emphasizing the importance of eliminating rent-seeking activities that rely on the various forms of government protection and subsidies. This recommendation implies that the reliance on the protection and subsidies is the salient feature of the firms in that

⁴¹ See Kep.10/M.EKUI/1999.

region that lead to the prevalence of crony capitalisms (Pomerleano, 1998). Consistent with this view, the ADB (2001) notes that, in the earlier phase of long-term industrial development plans⁴², the Indonesian government provides emerging industries with various protections and low-interest rates. This strategy is believed to create the industrialist elite: predominantly the families with strong links to General Soeharto and his ruling political party. Although General Soeharto resigned from the office in the earlier part of 1999, the mutual relationship between the political elite and the families persists⁴³. According to Nam (2004; 2004), the excessive government protection is more likely to prevent fair competition and consequently lessen the effectiveness of the market for corporate control.

The literature claims that the market for corporate control is an important governance mechanism (Jensen & Ruback, 1983; Berglöf & Claessens, 2004), where the effectiveness of this mechanism requires a liquid and efficient market, a strict trading rule, and the adequate disclosure of information (Maher & Andersson, 1999; World Bank, 2005). However, such a market in Asian economies has yet to make a satisfactory progress (Nam, 2004; Nam & Nam, 2004) as the capital markets in these economies are characterized by a thin trading volume, low liquidity, and large volatility (Zhuang, 1999). For example, an Indonesian-based study by Setiawan and Hartono (2003) finds that the market reacts positively to dividend increase announcements suggesting that the Indonesian capital market fits semi-efficient form in term of information. However, this study finds that the market reaction to such announcements by growth firms differ insignificantly from those of non-growth firms, suggesting a failure to support the

⁴² The industrialization began in the early 1970s when the government endorsed the continuous long-term industrial development plan. These plans were originated by General Soeharto who established the government under the title of Orde Baru (New Order). The plans focused on the agriculture-based industry in the earlier phases, manufacture-based in the mid-term and high tech-based industry in the long-term stages.

⁴³ For example Tempo (national weekly magazine, 17 November, 2008) reports that there was a strong signal that the General Yudhoyono administration (the existing President) ordered the capital market agencies (JSX and CMSA) to suspend Bumi Resources Tbk in order to prevent this share from dropping further in its price. Bumi Resources Tbk is owned by the Bakrie family, where one of the family members (Aburizal Bakrie) serves as the Ministry of Social Welfare. Perkins (2005) presents anecdotal evidence of such a relationship and uses “corporatocracy” as the term to represent such a relationship.

hypothesis that Indonesian capital markets fit semi-efficient form with respect to decision.

During 1992-1997, Indonesia experienced 40 mergers and acquisitions in the country (2001). However, there were only five external takeovers, while the rest were internal takeovers for tax purposes, indicating that the market disciplinary mechanism, through hostile takeover, was inactive in Indonesia. Accordingly, such a market has been claimed as a discouraging corporate market for corporate control (Zhuang, 1999). Although merger and acquisition occurs after the crisis, Nam, Kang and Kim (1999, p.2) argue that the existence of the takeover of non-financial firms and banks by foreign investors during corporate and financial sector restructuring is more likely to reflect "...fire sale in the midst of crisis than the emergence of an active market for corporate control".

4.4. Firm-level Governance in Indonesia

Although corporate governance might be argued as being market-induced mechanism, OECD believes that a regulation system and code of conduct concerning corporate governance are necessary in order to facilitate the effectiveness of such governance. Accordingly, the discussion of corporate governance in a particular country should refer to a specific regulation regarding the corporate governance. Within Indonesian context, the central features of the Indonesian legal system regulating the corporate sector⁴⁴ are Company Law (CL) 40/2007 and Capital Market Law (CML) 2005 that provide the most relevant regulatory framework of corporate governance (Tabalujan, 2002). The CML provides the basic provision of the authority and responsibilities of the Ministry of Finance, CMSA and JSX in governing the mechanisms of the stock exchange. CL provides general mandatory guidance for organizational structure, decision making

⁴⁴ The House of Representatives ratified the CL in 2007, that replaces CL 1995, and CML in 1995. Prior to the enactment of CL 1995, official business law is Wetboek van Koophandel, Staatsbald 1847 and Ordonnantie op de Indonesische Maatschappij op Aandeelen, Staatsbald 1939, enacted by the Dutch colonial government. Thus, although Indonesia gained its independence almost fifty years ago, the basic regulations remain to follow corporate acts enacted by the Dutch government in the period of colonial system.

mechanisms, the rights and obligations of shareholders and the fiduciary duties of the board of directors and the board of commissioners.

CL stipulates that the bottom line of corporate control and decision making rests in the hand of shareholders where the shareholders might delegate their decision making rights to the board of commissioners and board of directors. Therefore, the governance of corporation in Indonesia involves shareholders, board of commissioners and board of directors. Figure 1 exhibits the typical structure of a publicly listed company based on the CL and its comparison with the Netherlands two-tier model and the US one-tier system⁴⁵.

Figure 1: Organizational Structure of a Publicly Listed Company in USA, the Netherland and Indonesia

One-tier system USA	Two-tier system NETHERLAND	Two-tier system INDONESIA
Shareholder meeting	Shareholder meeting	Shareholder meeting
Board of Directors	Supervisory Board	Board of Commissioners
Management	Management Board	Board of Directors
Middle Management	Middle Management	Middle Management

Sources: Postma et al. (1999), Indonesian Company Law 2007, Anand (2008)

⁴⁵ Under Indonesian jurisdiction, the company might choose one of the forms permitted by law, including personal reliance service, commanditer verechnistze, and limited liabilities.

Figure 1 reveals that the shareholders' meeting is the supreme institution of Indonesian firms. Ordinary shareholder's meetings should be held at least once per year within the first six months after the year end. Invitations should be made no later than fourteen days prior to the meeting by registered mail, and announcements of the meetings should be published in the two national newspapers. At least half of all shareholders should attend the meeting in order for strategic decisions to be legitimate; unless the firm's Article of Association (AoA) stipulates a higher shareholder representation. If the quorum is not reached, a second invitation is made and the quorum is one-third of total shareholders. If a second meeting fails, the district court will take over the quorum upon the request of the company. Extraordinary meetings might be held upon the request of shareholders with at least ten percent stockholdings.

The board of directors and the board of commissioners are the subordinated institutions of shareholders meeting. The directors and commissioners are elected by shareholders that diverge from the US and Netherlands models where the supervisory board or the board of directors are elected by shareholders and subsequently the supervisory board or the board of directors elect management board or top management team. Therefore, within Indonesian context, the board of commissioners and the board of directors are parallel institutions.

4.4.1. Ownership and Control

The CL grants shareholders voting rights in a shareholders' meeting which enables them to involve in the decision making process. The minimum number of shareholders required to be represented in the shareholders' meeting varies across corporate actions. Changes in AoA require two-thirds of shareholders to be represented, and decisions should be approved by two-thirds of those attending. Mergers, transfers of asset, bankruptcy, and dissolution should be attended by three-quarters of the shareholders, and the decision should be approved by three-quarters of attendees. However, CL specifies that shareholders or their representatives should attend the general meeting in order to be able to exercise their voting rights. This provision eliminates the possibility

of proxy voting and therefore prevents the lower-cost mechanism of voting to work⁴⁶. Moreover, CL stipulates that the official voting system is one share one vote and follows simple majority rule, unless the AoA state otherwise. Although this provision does not necessarily prevent cumulative voting, simple majority rules enables controlling shareholders to easily outvote any minority proposals, leading to the case where majority control is left unchallenged.

CL provides shareholders with the right to obtain sufficient and accurate information about company operation, and requires companies to disclose information necessary for investment decisions (Article 9). Complementary to this act, CMSA requires companies to disclose the quarterly financial statement, transactions by significant shareholders, significant non-financial information, and inter-company affiliations such as affiliated lending or guarantees (KEP-17/PM/2002). CMSA also mandates the firm and public auditors to comply with auditing rules (KEP-20/2002). Further, CMSA and JSX also require the firms to establish an independent board committee responsible for auditing assignments and designed to promote the accuracy of information (KEP-03/2000, KEP-40/2003 and KEP-41/2003).

Article 45 regulates the dissenting right in the event of disagreement with corporate action and grants shareholders the right to request redemption of their shares at a normal and reasonable price. Article 51 provides shareholders with pre-emptive rights in the event that additional shares are issued. In addition, both CL and CMSA decrees stipulate severe penalties for management and directors' misconduct behaviour. CL (Article 30) specifies the mechanisms to resolve a dispute between firms and shareholders that includes the right to apply for the court to investigate the company, the right to file a lawsuit against management and directors, and the right to claim dissolution of the company. This mechanism enables shareholders to inspect the company's documents necessary under particular circumstances with respect to the magistrate's decision.

⁴⁶ According to Alijoyo et al. (2004) domestic investors are widely spread over the country and therefore the cost to attend the meeting is considerably high. Further, they claim that several companies have taken corporate action (mergers, major sales, acquisitions, and significant related party transactions) in the shareholders' meetings where the minimum quorums are less than those required by regulation.

However, the right to call for court intervention is only entitled by shareholders or groups of shareholders with at least ten percent stock ownership. As this shareholding level is the exception rather than the norm in Indonesia (Claessens et al., 2000a), this provision potentially protects the firms from the minority investors' litigation⁴⁷.

Indonesia exhibits a relatively high concentration of ownership in the hands of a few families (Asian Development Bank, 2000; 2001). Major and top five families own 16.6% and 40.7% of total outstanding shares of listed companies respectively (Claessens, Djankov & Lang, 2000). The median shareholding by the top three immediate shareholders is 62% in Indonesia, 12% in the US, 28% in Australia, 15% in the UK, 13% in Japan, and 20% in Korea (La Porta et al., 1998). These studies indicate that Indonesia exhibits the highest ownership concentration in the East Asian region and around the world. Shleifer and Vishny (1997) argue that higher ownership concentration, to some extent, provides majority owners with unchallenged control as such owners possess sufficient voting power to outvote minority shareholders proposals. Consequently, the agency problems in Indonesia stem from the conflict between majority and minority shareholders.

The determinants of ownership concentration have been attributed to the effectiveness of the legal system and cultural responsibility. La Porta et al. (1999) contend that property rights can be enforced by the state and shareholders. In economies where property rights enforcement by the state is weak, the shareholders will enhance the power of enforcement through increasing and accumulating ownership of the firm. In other words, if shareholders perceive that the legal system is unable to properly protect their rights against being compromised by company insiders, one way to protect their investment is to become a controlling shareholder with concentrated ownership (Nam, 2001). This argument seems to be empirically supported in the Indonesian setting as this country demonstrates lower investor protection provided by the legal system and at the same time higher ownership concentration. According to Shleifer and Vishny (1997), the

⁴⁷ In Korea, for example, the right to file a lawsuit against a breach of management fiduciary duties is entitled to a group of shareholders with 0.1% stockholding.

benefits of ownership concentration are larger in less developed countries where property rights are not well defined and protected by the judicial system.

Complementary to the legal perspective, Indonesia culture has been claimed as being heavily influenced by Confucianism (Adnan, Chatterjee & Nankervis, 2003). In such culture, the individual is expected to support a hierarchical system of social relations, and the emphasis is on the value of family and filial piety, implying the head of the family is responsible for fulfilling family obligation "...by themselves providing job opportunities to their family members" (Nam, 2001, p.6)⁴⁸. In this circumstance, higher ownership concentration enables majority owners to appoint their family members to serve in management and on the boards as it provides the owners with almost complete control of the firms. Indeed, in most Asian countries, "...controlling owners are typically preoccupied with conducting the managerial function themselves" (Nam, 2003, p.2) and leads to the family-based governance system. Accordingly, the existence of family-based firms in Asia could be interpreted as a function of this cultural responsibility.

Asian culture is grounded on family values; one fundamental one being that a family is responsible for maintaining its wealth over generations (Backman, 2004; Morrison & Conaway, 2007)⁴⁹. This implies that the survival of family-based firms is an important aspect of this culture that might be achieved through developing a close relationship within political circles⁵⁰. Nam (2001) argues that such a relationship creates mutual symbiosis, where the family provides political contributions and, in return, receives particular protection and support. This view relies on the premise that elites are self-interested and they cooperate to entrench themselves, even at considerable cost (Morck & Steier, 2007). In this circumstance, the private benefit of control would be easily secured that enables a controlling family to accumulate the wealth, at the expense of

⁴⁸ This view is consistent with expropriation hypothesis advanced by La Porta et al. (2000) claiming that expropriation might take the form of diversion of corporate opportunities from the firm and appointing possibly unqualified family members to managerial positions. In Asian culture, the family boundary usually extends well beyond nuclear families (Nam, 2001).

⁴⁹ Gadhoum (2000) supports this view and argues that family members benefit from on-the-job-consumption and prefer free cash flows in order to accumulate wealth for their descendents.

⁵⁰ See Lindblad (2004) for further discussion of such relationships in the context of Indonesia.

minority shareholders⁵¹. Nevertheless, such relationships might be achieved whenever majority shareholders control substantial proportions of corporate ownership that facilitate them securing rent-seeking activities and preventing information leaks (Fan & Wong, 2002).

The problem associated with the ownership concentration is further exacerbated by the pattern of corporate ownership. Claessens, Djankov and Lang (2000) find that 67% of listed companies in Indonesia are subordinately owned by other companies, controlled by the same shareholder, forming pyramidal ownership. The same study also finds crossholding patterns in a few companies⁵². These forms of ownership have been claimed as creating a divergence between ownership and control rights and serving as a means for majority owners to extend their control of the firms (La Porta et al., 1999). Eventually, this divergence determines the ability and incentives of the controlling owners to deprive minority shareholders of their rights (La Porta et al., 2002).

According to Claessens et al. (2002), the ratio of divergence in Indonesia is 78% and this figure is among the highest in East Asian countries. This finding suggests that the controlling right of majority shareholders substantially exceeds their ownership right. The same study also finds an inverse relationship between the ratio of such divergence and company performance, suggesting that this wedge constrains the firms from achieving better organizational outcomes. The finding implies that such forms of ownership lessens the sensitivity between the wealth of controlling owners and company performance, and therefore provides incremental incentives to commit expropriation of minority shareholders. Johnson et al. (2000) believe that such patterns of ownership might serve as a legitimate tunnel for the controlling owners to divert firms' resources.

The wedge between voting and control rights requires the existence of subordinating firms controlled by the same owners, where the higher wedge indicates the higher number of subordinating firms involved in the pyramidal ownership (Morck & Yeung,

⁵¹ See for example Baek et al. (2004) in the case of internal mergers in Korea.

⁵² Company Act 1995 prohibits direct crossholding while indirect crossholding is not stipulated, nor regulated.

2003). Consistent with this view, controlling families in Indonesia engage in excessive business diversification (Claessens et al., 1999) that lead to a higher ratio of divergence between ownership and control. Patrick (2001) claims that such a diversification forms a business group that typically also controls a bank within the group, where the primary role of the bank is to collect public funds and channel the funds to other companies within the group⁵³. He argues that the banks serve as a “cash cow” for other companies controlled by the same family. This pattern of business groups leaves the bank management with little independence to exercise prudent and sound business decisions. Consequently, monitoring by the bank is more likely to be absent as the creditor and debtor are owned by the same shareholder.

Claessens, Djankov and Lang (2000) conclude that 53.4% of Indonesian listed firms have no second largest owner with at least 10% shareholding, suggesting the absence of unrelated large shareholders in most firms. According to Maury and Pajuste (2005), the presence of unrelated blockholders, who are independent of controlling owners, might serve as governance mechanisms as such shareholders have the incentive and economic rationale to monitor management. However, Faccio, Lang and Young (2001) indicate the different role of blockholders across economies. Specifically they suggest that blockholders promote contestability toward the control of majority shareholders in European countries and therefore serve as a monitoring mechanism. In Asian countries, blockholders are more likely to collude with majority shareholders to divert firms’ resources. Consistent with this view, the work of Menkhoff and Gerke (2002) reveals the prevalence of interlocking family control that may exacerbate agency problems in East Asia. These studies indicate that the presence of domestic blockholders in Indonesia play an insignificant monitoring role.

4.4.2. The Board of Directors and Management

The CL requires firms incorporated under Indonesian jurisdiction to establish “dewan direksi” (a board of directors) and “dewan komisaris” (a board of commissioners).

⁵³ The Banking Law prohibits the bank to own company shares directly or indirectly. This provision is different from those of Germany and Italy that permits the bank to own firms’ shares.

Companies that go public or engaged in public funds or issue obligations must have at least two directors and two commissioners, while the private company is obligated to establish one commissioner. Both management and supervisory boards are appointed directly by shareholders at the annual general meeting, and hence, those two boards are parallel internal institutions (figure 1). Therefore, this official pattern of appointment creates the divergence from the original model. Nevertheless, the boards possess the authority to dismiss management (World Bank, 2005) and this, it is argued by Mizruchi (1983), is the most important aspect of the board power as it grants the board with the bottom line of control. According to Perrow (1976), this right will allow the board to subordinately leave management decision to the executives and still retain control. This right provides the board with the power to serve as governance mechanisms that potentially affect management behaviour.

CL stipulates that the directors are responsible for performing managerial duties and to be involved in the daily operations of the company (art 1.4 and 82). The board of commissioners is held liable for monitoring and supervising the board of directors (art 1.4 and 97). In the two-tier system, the managerial duties and day-to-day operation is the responsibility of management board while the monitoring is the liability of the supervisory board (Maassen, 2002). In one-tier system, management is responsible for performing managerial duties while the board of directors is held liable for monitoring and supervising management (Monks & Minow, 2004; Clarke, 2007). Accordingly, based on their fiduciary duties, in the Indonesian context, the board of directors is best viewed as the management team while the board of commissioners is identical to the board of directors in the one-tier system and the supervisory board in a two-tier system⁵⁴.

The board of commissioners comprises non-executive commissioners entirely as the CL prohibits an individual from serving in both board of commissioners and the board of directors. Based on this provision, the board of commissioners might be argued as

⁵⁴ Although literally confusing, this implies that studying the board in Indonesia should refer to the board of commissioners (dewan komisaris) rather than the board of directors (dewan direksi).

adopting two-tier system. Although the scope of responsibility of the board might include advisory and control duties, the formal separation suggests that the two-tier system emphasizes the monitoring role as compared to the one-tier system (Moerland, 1995). As the board of commissioners adopts two-tier system, accordingly, the board comprises non-executive commissioners entirely. Such commissioners have been referred to as outsider commissioners that have been argued as being independent of management and representing the interest of diffused shareholders against opportunistic behaviour of management. However, corporate ownership in Indonesia is concentrated in the hand of controlling owners that leads to the divergence of interest between those of controlling owners and minority shareholders rather than traditional manager-shareholders conflict. Therefore, the concept of outsider commissioners in Indonesia requires a modification in accordance with its specific agency problem.

The concept of independent commissioners hinges upon their affiliation that serves as a basis in disentangling outsider and insider commissioners. Outsider commissioners refer to individuals without any relation with management where the only relation is their commissionership. On the other hand, insider commissioners are individuals who have any relation with management. This might include commissioners who are former employee, who have current business relation, who are nominated and appointed by management. However, as the agency problem in Indonesia is related to the conflict between controlling owners and minority shareholders, the affiliation of the commissioners might refer to the controlling owners instead of management⁵⁵. Accordingly, affiliated commissioners refer to individuals who are the family members of controlling owners, are former and current employee of business group owned by controlling shareholders, have business relationship with business group owned by

⁵⁵ In 2007, the House of Representative ratifies Company Law 2007 and therefore Company Law 1995 became ineffective. However, CL 2007 and CL 1995 are quite similar in defining the controlling family although CL 2007 provides a more detailed explanation as compared to CL 1995. The difference between these laws is in regard with the procedure of registration, the responsibility of corporate secretary, the procedure of bankruptcy arrangement, the minimum amount of paid-in-capital, the form of private company, the eligibility requirement to bid for government contract, and the detail of explanation. Accordingly, it is acceptable to rely also on CL1995 in defining controlling family. Indeed, the study uses data as of 31/12/2002 where Company Law 1995 is still effective.

controlling shareholders, and are nominated and appointed by controlling owners⁵⁶. Within Indonesian context, outsider commissioners are individuals without any affiliation with controlling owners other than their commissionerships.

In 2001, the JSX agency officially required that listed firms' board of commissioners comprise at least 30% independent commissioners, or that the number of independent commissioners be proportional to the shareholding by minority investors, whichever is higher⁵⁷. The agency specifies that an independent commissioner is an individual without any affiliation with management, commissioner, or controlling owner, and do not serve as commissioner in other affiliated firm (interlocking commissioner)⁵⁸.

Although the JSX highlights the affiliation with management and commissioners, such requirement is based on the presumption that the existing management and commissioners are nominated and appointed by controlling owners. Hence, the requirement underlines the importance of affiliation with controlling owners in defining independent commissioners. Indeed, the requirement confirms the framework where the family, instead of individuals serve as the unit of analysis. Accordingly, the concept of independent commissioners is relevant to Indonesian context although that country adopts a two-tier model.

⁵⁶ This definition is consistent with the decree of CMSA (SE-03/PM/2000) and the decree of JSX (Kep-315/BEJ/062000, and Kep-339/BEJ/07-2001). The concept of independent directors is not stipulated in either Company Law 1995 or CL2007. Independent directors might be found in specific regulations which are endorsed by Capital Market Supervisory Agency and Jakarta Stock Exchange Agency. However, those agencies are officially established under Capital Market Law that grants them authority to regulate capital market in Indonesia (see the hierarchy of Indonesian legal system in Appendix 3). Accordingly, the decrees might be viewed as official regulation in the context of Indonesia. The CL 1995 and CL2007 use the term "controlling shareholders" where such a term and its detailed explanation serve as a legal basis of specific regulations endorsed by lower agencies such as CMSA and JSX in defining independent commissioners. The term implies that the affiliation of commissioners (or the member of supervisory board in one-tier system and directors in one-tier system) should refer to controlling family. Therefore, it is justifiable to rely on the decree of CMSA and of JSX in defining independent commissioners. The term also implies that corporate governance in Indonesia already hinges upon the family as the unit of analysis.

⁵⁷ In accordance with the Indonesian context, the term "board" or "the board of directors" refers to the board of commissioners for the rest of this dissertation unless stated otherwise.

⁵⁸ SE-03/PM/2000, Kep-315/BEJ/062000, and Kep-339/BEJ/07-2001 art C.2.

The agency believes that the effectiveness of the board in conducting their fiduciary duties might be enhanced through mandating an appropriate board composition⁵⁹. The JSX asserts that the appointment of independent directors is necessarily needed in order to promote sound governance practice. This assertion is consistent with those of other countries mandating the inclusion of independent directors on the board (Dahya & McConnel, 2005). Therefore, the requirement provides supportive evidence that Indonesia follows the global convergence toward a more prominent role of independent directors. Such convergence assumes that the boards with more independent directors will lead to better decisions

The requirement of appointing independent directors is intended to promote the sound corporate governance that might provide minority shareholders with a channel to challenge majority shareholders control. La Porta et al. (2000) suggest that governance improvement, to some extent, will reduce the private benefit of control by majority shareholders. Accordingly, majority owners have a strong incentive to protect their private benefit of control and to prevent the improvement of corporate governance that might invite a threat to their control (Nam, 2001). This view implies that it is infeasible to expect controlling shareholders to adopt governance improvement voluntarily as poor corporate governance enables them to secure arms-length transactions, rent seeking, and lower costs of expropriation (La Porta et al., 2000). Consequently, it might be argued that the inclusion of independent directors in Indonesia are contingent upon the requirement and that such directors are absent in the Indonesian listed firms prior to the requirement⁶⁰.

4.5. Conclusion

The Indonesian environmental setting is typified by weak investor protection provided by the legal system, an inactive market for corporate control and ownership concentration. Although unrelated large shareholders might serve as a governance mechanism, the existence of interlocking families in Indonesia might prevent this

⁵⁹ Kep-339/BEJ/07-2001 art C.1

⁶⁰ Nowland (2008) support this notion claiming that, traditionally, corporate governance is not a priority in Asia until the crisis hit that region.

mechanism from working effectively. Accordingly, the control of the firms rests in the hands of majority owners and the agency conflicts stem from the conflict between majority and minority shareholders. At the firm level, family control is further enhanced through the appointment of family members to serve in management and on the boards. The board of directors adopt a two-tier system that diverges from its original model. The next chapter will incorporate the feature of the institutional setting of Indonesia in the hypothesis development.

Chapter 5: Hypothesis Development

5.1. Introduction

In the previous chapters, the theoretical and empirical issues are discussed. It is documented that corporate governance, in general, and board composition in particular, potentially determine the outcome of the firm. However, the impact of board composition on firm performance is potentially affected by the presence of other governance mechanisms. In the case of Indonesia, such mechanisms consist of large shareholders and the controlling family involvement on the board and in management.

This chapter discusses the hypothesis development that serves as the basis for the empirical test of the underlying theory. This chapter starts by developing hypotheses predicting the relationship between the proportion of independent directors, leadership structure and firm performance. The next section incorporates the impact of other governance mechanisms, specific to the Indonesian context, on the relationship between board composition and firm performance. The last section summarizes the discussions.

5.2. Hypotheses

5.2.1. Leadership Structure

One major problem in implementing sound governance practice in Indonesia is an ineffective board of directors in conducting their fiduciary duties (ADB, 2000). Literature suggests that leadership structure determines the effectiveness of board monitoring role as such a structure dictates the board independence necessary for conducting control decisions (Dalton et al., 1998; Rhoades, Rechner & Sundaramurthy, 2000). The proponents of combined leadership argue that such a structure enhances the information flow, between the board and management that reduces information asymmetry. This will enable the boards to provide management with better advice. However, Jensen (1993) posits that separated leadership delivers a better position to the board in monitoring management as this structure encourages the separation between management decisions and control decisions. Although the advantages and disadvantages of a particular leadership structure might be disputed, some studies find

that firms that adopt combined leadership exhibit different decisions and firm performance as compared to the firm with separated leadership (Carapeto, Lasfer & Machera, 2005; Desai, Kroll & Wright, 2003; Pi & Timme, 1993).

Research investigating board composition in one-tier countries categorizes the directors as either being insider, grey or independent where such classification refers to the directors affiliation with management (Millstein & MacAvoy, 1998; Clarke, 2007). This view relies on the dispersed ownership model where the agency problem stems from the conflict between managers and shareholders. However, Lukviarman (2004) argues that the categorization in one-tier studies is applicable to Indonesia although this economy adopts a two-tier board system. Nevertheless, he suggests that the definition of director affiliation should refer to the controlling family, rather than the management, as the ownership of Indonesian firm is concentrated in the hand of a few wealthy controlling owners.

An important issue pertinent to the ownership concentration by controlling family in Asia is the prevalence of family-based governance where all strategic positions in the firm reserved for family members (Menkhoff & Gerke, 2002). In Indonesia, the controlling owners typically appoint their family members to serve in management (Claessens et al., 2002) and on the board (Tabalujan, 2002). Following the approach using the family as the unit of analysis, the directors who are controlling-family members could be argued as representing the interest of their family and therefore the interests of such directors are assumed to be necessarily similar to those of management. This line of reasoning implies that the directors who are the family members of controlling owners have identical properties with the insider directors. This argument offers a rationale to justify that the substance of combined leadership to some extent is also prevalent empirically in a two-tier regime whenever the family member of controlling owner serves as a board chairperson.

In the context of Indonesia, the agency problem stems from the conflict between controlling owners and the minority shareholders, where the weak legal enforcement and

the absence of the market for corporate control have been claimed as facilitating controlling-owners ability to divert firm resources (Krishnamurti, Sevic & Sevic, 2005). In such an environment, Scott (1999) argues that strengthening of internal governance mechanisms will create immediate benefit, while the benefit from development of markets for corporate control is expected to emerge in the long-term. In the context of Indonesia, this view implies that it would be beneficial to enhance the board independence in order to compensate for the absence of external governance mechanisms. This argument suggests that that a controlling-family member serving as the board chairperson will discourage board independence which facilitates the controlling-owners to retain their private benefit of control. In contrast, the presence of an independent director serving as board chairperson might promote board independence. Accordingly, such leadership might enhance board monitoring effectiveness that might lead to better firm performance. This leads to the testable hypothesis:

H_{1a}: The board's independent leadership is positively related to firm performance.

5.2.2. The Proportion of Independent Directors

The agency literature investigating the board of directors focuses on the extent to which the level of independence of management determines the board effectiveness in making the firm's management accountable. Agency theory posits that the independence of management is best represented by outside directors and therefore the board would be in a better position to exercise a monitoring role whenever it consists of sufficient independent directors. However, the existing empirical literature investigating the relationship between board independence and firm performance produces inconclusive findings. Moreover, the empirical work has been limited to the developed economies such as the European countries, US, and UK. There is a lack of studies addressing this issue with regard to developing countries where a different institutional setting may exist.

The global convergence toward greater outside director representation relies on the assumption that boards with more independent directors tend to make better decisions (Dahya and McConnel, 2005). This assumption implies that the advantages and the disadvantages of independent directors are relevant to the developing countries such as Indonesia. However, there exist the differences across countries in terms of the legal system, economic environment, and the strength of capital markets that constitute the uniqueness of the institutional setting of a particular economy. According to La Porta et al. (1998), the institutional setting may lead to different needs of the governance configuration and its effectiveness, suggesting that the governance mechanism that works well in one country may produce a different outcome in another environment with different institutional factors.

Within the agency framework, an effective board monitoring is the epicentre of firm-level governance as it provides the first-line defence against opportunistic behaviour of management. As such, the independent director is the standard indicator of the governance mechanism exercised by the firms. A study by Rosenstein and Wyatt (1990) offers supportive evidence that adding independent directors to the board is perceived as encouraging more effective monitoring of manager. This study is consistent with the standard view of agency theory predicting that the interests of non-owner managers tend to diverge from those of shareholders if left unattended. In this circumstance, independent directors could be seen as an important mechanism as they have the incentive to better monitor management.

Rediker and Seth (1995) argue that there exist interdependence relationships among governance mechanisms. Consequently, different portfolios of governance mechanisms may produce equal outcomes (Danielson & Karpoff, 1998; Heinrich, 1999) and therefore the firms may choose a certain governance configuration across the mechanism or within the mechanism that most effectively meets their organizational and environmental context (Du & Dei, 2002). This argument implies that the importance of the board as a monitoring device depends on the presence of other strong monitoring mechanisms. In support of this notion, a study by Agrawal and Knoeber (1996) confirms

that board monitoring is less important in the presence of multiplicity of control mechanisms in the US that have a strong institutional environment. This setting has been argued as enhancing the simultaneous working of internal and external governance mechanisms in reducing the self-interest behaviour of agents (Brunello, Graziano & Parigi, 2003). In contrast, Indonesia has been documented as being characterized by a weak institutional setting (Patrick, 2001), less developed and an illiquid market, weak legal and economic environment, and highly family-based ownership concentration (Zhuang, 1999). Accordingly, it might be argued that the board monitoring is of considerable important in Indonesia, where the absence of multiplicity of control mechanisms has been proven. As the monitoring role is assumed to be best performed by independent directors, it is predicted that a higher outside director's representation will reduce agency costs and consequently improve firm performance. This leads to the testable hypothesis:

H_{1b}: The proportion of independent directors is positively related to firm performance.

5.2.3. Interdependence between Board of Directors and Other Governance

Mechanisms

Although the board composition might have a relationship with firm performance, such a relationship is potentially affected by the presence of other governance mechanisms (Agrawal & Knoeber, 1996). This view is based on the presumption of the interdependence among governance mechanisms where different configurations of corporate governance might produce equal outcomes (Heinrich, 1999). Interdependence refers to the substitutability and complementary relationships implying that the importance of a board monitoring depends and is contingent to the presence of multiplicity of control mechanisms (Rediker & Seth, 1995). However, the exact form of interdependence as the whether the form is being complementary or substitute is far from obvious. Nevertheless, literature suggests that studies investigating the association between board composition and firm performance should control for the effect of other governance mechanisms. Methodologically, such a study is required to bring other governance mechanism available within specific institutional setting into the model. In

Indonesia, other governance mechanisms available are ownership structure and the controlling family involvement in management and in the board (see section 2.4.4 and 4.4 for detailed discussion). Accordingly, this dissertation controls for the effect of such mechanisms on the relationship between board composition and firm performance.

5.2.3.1. Controlling-Family Ownership

Agency theory posits that the board is an internal institution representing shareholders interests and is primarily assigned to monitor management (Zahra & Pearce, 1989). The theory suggests that the effectiveness of the monitoring role is determined by the negotiation between directors and manager, where the outcome of such negotiation is affected by the power of the negotiating parties (Hermalin & Weisbach, 2003). This implies that boards would effectively monitor management whenever they have sufficient power to exercise their role. Eventually, this power will enable the board to influence management decision and leave the operational course of strategic policy to management (Bunting & Mizruchi, 1982). According to Erickson et al. (2005), the directors represent the power of the contracting parties they represent.

Within the nexus of the contract view, corporate shares have been quoted as a property arrangement that grants shareholders the power (through voting rights) and incentive (through cash flow rights) to negotiate and enforce contracts with various parties (Fan & Wong, 2002). Lannoo (1999) argues that the structure of corporate share ownership serves as a basis for the distribution of control and the power of contracting parties within an organization. This suggests that an ownership concentration provides majority shareholders with more power to control the firm's operation in accordance with their interests. In such ownership, the agency problems stem from the conflict between controlling owners and minority shareholders as the management acts solely for the majority shareholder's interest. Consequently, the power of the board is determined by ownership structure as they represent the power of contracting parties. In the case of Indonesia, the JSX posits that the inclusion of independent directors is intended to represent minority shareholder in governing the firm. This implies that boards are less

likely to have significant power in challenging management that represents the interest of controlling owners.

The viability of separation between ownership and control hinges upon the model where the primary mechanism of disciplining managers relies on the market for corporate control, with the assistance of a monitoring device (Fama & Jensen, 1983; 1983). This view suggests that the effectiveness of the board monitoring role is contingent upon the presence of a market for corporate control. Put differently, the importance of the board monitoring role is complementarily related to the external governance mechanism, in which the market for corporate control is the necessary condition for effective internal governance within the firm (Fama, 1980). Consequently, the board monitoring role would be effective in alleviating the agency problem whenever an efficient market for corporate control exists. Although Maug (1998) casts a doubt on the existence of the trade-off between liquidity and control associated with large shareholding, there is a high incidence of governance research claiming that ownership concentration necessarily leads to an illiquid capital market (Brunello, Graziano & Parigi, 2003; Dehaene, De Vuyst & Ooghe, 2001; Erickson et al., 2005; Park & Shin, 2004). This line of reasoning implies that the efficient capital market is more likely to be absent in Indonesia as this country exhibits ownership concentration in the hands of a few wealthy families (Claessens, Djankov & Lang, 2000).

Fama and Jensen (1983) suggest that effective monitoring by the board requires this institution to be independent of management, which might be achieved through a higher proportion of independent directors and a separated leadership. However, the previous discussion reveals that the distribution of power of contracting parties and the presence of a strong market for corporate control have been argued as determining the effectiveness of the board monitoring role, where such power and market depend on the ownership structure. In this circumstance, Zahra and Pearce (1989) posit that the ownership structure is a moderating factor in the association between board composition and organizational outcome and accordingly, such association is moderated by the

presence of ownership concentration. Given that ownership concentration has been argued as moderating the effectiveness of the board monitoring role, it is predicted that

H_{2a}: The presence of ownership concentration will affect the association between the board's independent leadership and firm performance.

H_{2b}: The presence of ownership concentration will affect the association between the fraction of independent directors and firm performance.

5.2.3.2. Blockholders

Agency theory predicts that firm performance is inversely related to the opportunistic behaviour of agents where the agents have been assumed as having a tendency to pursue their own interests if left unattended (Jensen & Meckling, 1976). Gillan (2006) suggests that corporate governance that potentially affects the behaviour of contracting parties and the outcomes of the firms could be categorised as either being internal or external mechanisms. External mechanism relies on the market for corporate control (Jensen & Ruback, 1983) while internal mechanisms refer to the large shareholders (Jensen & Meckling, 1976), leverage (Gul, 2001) and board of directors (Wagner III, Stimpert & Fubara, 1998).

The large shareholder has appeared in the finance literature as a governance mechanism that might reduce the agency problem and increase firm performance. However, large shareholders might benefit the firm only when the management and ownership are separated (Nam, 2003). This view implies that the separation between management decisions and control decisions might be promoted by the presence of external blockholders. Dechow, Sloan and Sweeney (1996) posit that significant shareholding by external blockholders provides them with the incentive to monitor management and sufficient voting power to remove poor performing management. Empirical work find that the existence of external large shareholders positively related to corporate performance (Jones, Lee & Tompkins, 1997), increases the likelihood of the takeover of poor performing firms (Clyde, 1997) and lowers the level of earnings management (Jiambalvo, Rajgopal & Venkatachalam, 2002).

An important issue pertinent to the relationship between board composition and firm performance is the interdependence between governance mechanisms (Rediker and Seth, 1995). Although theoretical and empirical work demonstrates the absence of consensus as to whether the relationship between governance mechanisms complement or substitute each other, the failure to control for this issue has been quoted as producing inconsistent estimators and spurious findings (Agrawal and Knoeber, 1996). Börsch-Supan and Köke (2002) suggest that the presence of other governance mechanisms available within a specific institutional context should be addressed adequately in examining the relationship between board composition and firm performance. In the context of Indonesia, the governance mechanisms available are the presence of external large shareholders, either domestic or foreign institutional investors, and the board of directors, while lender monitoring and the market for corporate control have been proven as being insignificant mechanisms. As the interdependence implies that the effectiveness of the board monitoring role is contingent upon the presence of other strong governance mechanisms, it is predicted that

H_{2c}: The presence of external large shareholders will affect the association between the board's independent leadership and firm performance.

H_{2d}: The presence of external large shareholders will affect the association between the fraction of independent directors and firm performance.

5.2.3.3. Controlling-Family Involvement in Management and on the Boards

Controlling owners of Indonesian firms typically appoint their family members to serve in management (ADB, 2002). Using the family as the unit of analysis, this study suggests that such appointments might have important implications on corporate control. Within this framework, the individual shareholding of one controlling-family members serving in management is assumed to be identical to the aggregate shareholding of all family members. Consequently, such appointments might raise insider ownership concerns as the controlling family accounts for substantial ownership of the firm. Such ownership has been quoted as having two competing effects where its beneficial effect is contingent upon the level of shareholding. At the lower level, managerial ownership creates an incentive alignment effect that discourages managers from pursuing

opportunistic behaviour while, at a higher level, the entrenchment effect dominates the incentive alignment effect (Morck, Shleifer & Vishny, 1988).

The literature investigating managerial ownership focuses on the impact of such ownership on management behaviour. Jensen and Meckling (1976) suggest that managerial shareholding might serve as a governance mechanism as it promotes the convergence of interests of agents and principals. This view hinges upon the argument that such ownership raises the sensitivity of agents' wealth to firm performance. However, higher managerial ownership has been claimed as granting management sufficient power to outvote any undesired proposal in a voting contest. In the absence of strong investor protection provided by the legal system, this power necessarily enables management to secure their position and helps them pursue self-interest actions as they have the power to protect their job. Seifert, Gonenc and Wright (2005) find that managerial ownership is negatively related to firm performance in the US and the UK although the effect of managerial ownership might depend on the legal system and other governance mechanisms specific to a particular economy. Eventually, such power might lessen the sensitivity of managerial performance to the manager market for corporate control (Volpin, 2002). The work of Brunello, Graziano and Parigi (2003) reveals that higher insider-shareholding firms exhibit lower sensitivity of management turnover to firm performance as a consequence of managerial entrenchment.

As documented by Claessens et al. (2000), the average shareholding by controlling owners in Indonesia is 25.6%. This finding suggests that the family members of controlling owners serving in management have higher corporate ownership that provides them with sufficient power to entrench themselves. Eventually, such power might lead to the absence of the threat of dismissal, as a necessary condition for corporate control, and negate the link between CEO turnover and performance (Gibson, 2003). According to Mizruchi (1983), monitoring by the board would be ineffective whenever the board loses the bottom line of control as they are unable to remove poor performing managers. This view implies that managerial entrenchment leads to less governance by the board, suggesting that boards are less likely to be able to deliver

better firm performance provided by their independent monitoring. Accordingly, the association between board independence and firm performance will be lower in the firm with a higher number of family members serving in management. This lead to the testable hypothesis:

- H_{3a}: The presence of family members of controlling owners serving in management will affect the association between the board's independent leadership and firm performance.
- H_{3b}: The presence of family members of controlling owners serving in management will affect the association between the fraction of independent directors and firm performance.

Complementary to the involvement in management, the work of Tabalujan (2002) reveals that the prevalence of family members of controlling owners serving on the board is a salient feature of Indonesian listed firms. The convergence of interest hypothesis suggests that higher shareholding provides such family members with the incentive to improve firm performance as their wealth is significantly related to the firm performance and its sustainability (Jensen & Meckling, 1976). Moreover, the implicit contract among family members might reduce information asymmetry among family members of controlling owners serving on the board and in management (Wiwattanakantang, 2001). This view implies that the controlling family involvement on the board might benefit the firm as it reduces monitoring costs and alleviates agency problems. Accordingly such involvement might substitute for the importance of board independence in performing monitoring role.

However, Urriaga and Tribo (2004) argue that the family members of controlling owners share the same interest among them and accordingly, they act collectively. This proposition implies that the family members of controlling owners would pursue collective action with management in preserving the interests of their family. Consequently, the controlling family involvement on the board might serve as a channel for controlling owners to influence control decisions and combine these two decisions in their hand. Therefore, such involvement might reflect what Fama and Jensen (1983)

claim as signalling the absence of separation between management decisions and control decisions.

Despite their conflicting prediction, empirical studies support the notion that controlling owner's involvement on the board is negatively related to firm performance. Yeh, Ko and Su (2003) find that such involvement is negatively related to firm performance while the work of Ho and Wong (2001) reveals that the fraction of family members on the board has an adverse association with the level of disclosure. These findings are consistent with the view claiming that such involvement serves as an entrenchment device of controlling owners in order to insulate them from disciplinary action provided by an effective internal monitoring device (Yeh & Woitke, 2005).

Indonesia faces serious ineffective corporate governance (Nam, 2004) that results in a problem of expropriation by controlling owners (Claessens et al., 2002). Nam and Nam (2004) argue that such a problem might be alleviated by an effective board monitoring device, implying the importance of establishing an independent board that potentially prevents the controlling family from diverting firm resources. Such independence might be achieved through simultaneously adopting separated leadership and appointing a higher fraction of independent directors. In this circumstance, the higher fraction of independent directors is a complementary condition to the independent leadership in order to construct a higher level of board independence. Consequently, the involvement of a controlling family on the board would negate the link between the effectiveness of board monitoring and firm performance given that such involvement would lessen the board's independence from the controlling family. In other words, the association between board independence and firm performance will be lower in the firm with a higher number of family members of controlling owner serving on the board. Therefore it is predicted that

H_{3c}: The presence of family members of controlling owners serving on the board will affect the association between the board's independent leadership and firm performance.

H_{3d}: The presence of family members of controlling owners serving on the board will affect the association between the fraction of independent directors and firm performance.

5.3. Summary

This chapter presents hypotheses development derived from agency theory that serve as a basis for empirical testing (see Table 2 for summary of hypotheses). It is argued that board composition (leadership structure and the representation of outsider directors) potentially affects firm performance. However, the benefit of board monitoring might be affected by the presence of other governance mechanisms. The next chapter discusses the methodology of empirical hypothesis testing.

Table 2: Summary of Hypothesis

Number	Hypothesis
H _{1a} :	The board's independent leadership is positively related to firm performance.
H _{1b} :	The proportion of independent directors is positively related to firm performance.
H _{2a} :	The presence of ownership concentration will affect the association between the board's independent leadership and firm performance.
H _{2b} :	The presence of ownership concentration will affect the association between the fraction of independent directors and firm performance.
H _{2c} :	The presence of external large shareholders will affect the association between the board's independent leadership and firm performance.
H _{2d} :	The presence of external large shareholders will affect the association between the fraction of independent directors and firm performance.
H _{3a} :	The presence of family members of controlling owners serving in management will affect the association between the board's independent leadership and firm performance.
H _{3b} :	The presence of family members of controlling owners serving in management will affect the association between the fraction of independent directors and firm performance.
H _{3c} :	The presence of family members of controlling owners serving on the board will affect the association between the board's independent leadership and firm performance.
H _{3d} :	The presence of family members of controlling owners serving on the board will affect the association between the fraction of independent directors and firm performance.

Chapter 6: Research Method

6.1. Introduction

In the previous chapters, the theoretical and empirical issues, as well as proposed hypotheses development, were discussed. It was proposed that corporate governance, in general, and board structure in particular, determine the outcome of the firm. This chapter discusses the research methodology which serves as the basis for empirically examining the advanced hypotheses. The concept of methodology is derived from the research paradigm (Jupp, 2006). Accordingly, this chapter starts with the research paradigm in order to provide a justification for the methodological choice used in this study. The next sections discuss the research model, data and sampling, definition and measurement of variables, and statistical tools. The last section summarizes the discussions.

6.2. Research Paradigm

The research paradigm refers to the particular rules and standards for the scientific practice of the researchers in analysing and modelling the problems and their solutions (Burrell & Morgan, 1979). The particular choice of paradigm hinges upon a set of assumptions that relate to the underlying ontology and epistemology (Jupp, 2006). According to Peile (1994), the matrix of philosophical assumptions and paradigms forms the basic framework in developing research methodology.

Ontology pertains to the nature of reality and the way individuals recognize such reality that must underlie all investigation (Williams, 2003). Positivism relies on the deterministic assumption of the real world where reality could be broken down into particular segments (Peile, 1994). This assumption hinges upon the existence of order and regularity in the real world that formulates the deterministic approach and accordingly views reality as a redundant event (Burrell & Morgan, 1979). This paradigm's view is that an historical reality exists that is understandable, measurable and therefore predictable in a particular isolated context (Williams, 2003). The objective of the positivist is to describe and predict the nature of human behaviour that composes

certain social phenomena. By contrast, the interpretative or phenomenology paradigm posits that knowledge is contextual and reflects symbolic social construction and thus only partial reality is understandable in the isolated context (Jupp, 2006). The objective of such a school of thought is to promote the new construct beyond the previous understanding within social theory.

This study is intended to investigate the association between a board of directors' composition and firm performance that relies on the existing proposition regarding such association. Therefore the objective of the study is to obtain empirical confirmation of the existing underlying theory. Such proposition predicts that monitoring by the board of directors potentially affects the behaviour of contracting parties within the firm. This proposition hinges on the deterministic view of the positivism school of thought. Accordingly, this study starts out with the assumption that there exists the causal relationship between board composition and firm performance. Further, such a relationship could be isolated from other factors that might confound the empirical confirmation.

Epistemology refers to the issue of the way knowledge is acquired and communicated to others. Crotty (1998) argues that the positivist focuses on explaining the regularities of social phenomena that is irrespective to the certain value. Positivism utilizes an objective approach, where knowledge is obtained through objective observation and interpretation of phenomena. By contrast, the interpretative paradigm emphasizes the personal meaning of certain phenomena that leads to the interpretation specific to an individual (Henn, Weinstein & Foard, 2006). Accordingly, knowledge could only be acquired from intensive interaction between the researcher and the subject (Kalof, Dan & Dietz, 2008). The objective of this study is to investigate the regularities of phenomena being researched. As this places less emphasis on the personal interpretation of researched phenomena, the objective approach is considered the appropriate paradigm, where the construct used is assumed to be observable and measurable (Jupp, 2006). The objective approach requires proper construct definition and research method in order to facilitate the objective observation and interpretation of findings. The objective aspect is of the

prime importance in quantitative research, where the method is replicable and therefore the findings could be confirmed or refuted by other studies. According to Crotty (1998), the objective approach focuses on the generalisation of universally applied statements of particular propositions. This approach is consistent with the objective of this study in that it focuses on verifying or falsifying the existing theory. This focus implies that the hypotheses derived from underlying theory are subject to empirical test. Accordingly, this study starts with the existing model derived from existing theory concerning the relationship between board composition and firm performance.

6.3. Research Model

The basic model is derived from the monitoring hypothesis advanced by Alchian and Demsetz (1972). They argue that monitoring potentially induces the agent to pursue actions that are consistent with the interest of the principals. Within an agency framework, a board of directors serves as a primary monitoring mechanism where its independence of management determines the effectiveness of such a role (Fama & Jensen, 1983). The literature suggests that outsider directors represent independence of management implying that a better monitoring role might be achieved whenever the board is comprised of a sufficient proportion of outside directors (Dalton et al., 1998). As the firm performance is inversely related to self-interest action of agents, then effective monitoring by outside directors will be reflected in a better firm performance.

Agrawal and Knoeber (1996) argue that there exists interdependence among governance mechanisms suggesting that the importance and effectiveness of the board monitoring role are conditional on the presence of other governance mechanisms. Empirically, this view implies that the association between board composition and firm performance would be affected by the multiplicity of other control mechanisms. In the case of Indonesia, this study argues that the other governance mechanisms available are ownership by a controlling family, external large shareholders and controlling family involvement in management and on the boards. Accordingly, as presented in Figure 2, this study will control for the effect of such mechanisms in the relationship between board composition and firm performance.

Figure 2: Research Model

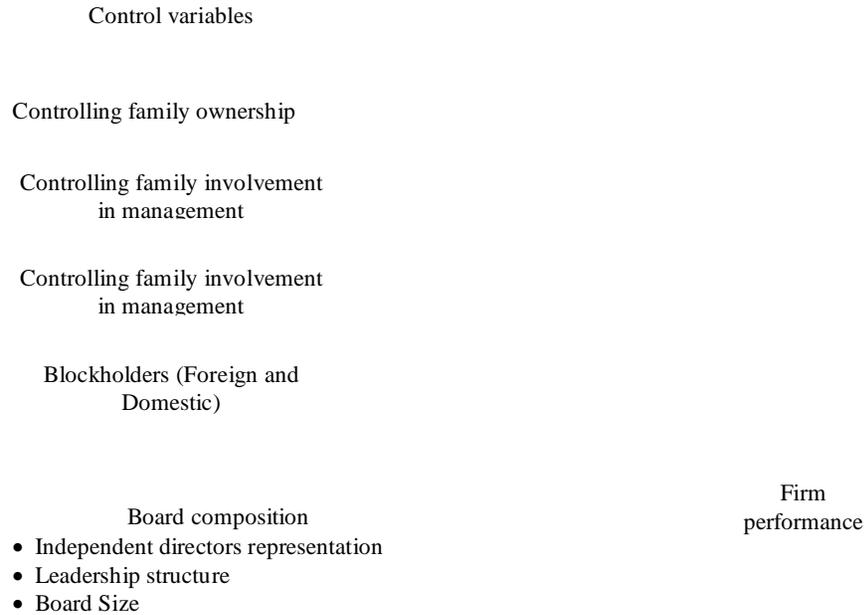


Figure 2 reveals that board composition determines firm performance, where such effect is moderated by the presence of other governance mechanisms. Based on the model, this study derives an empirical specification as presented in the following equation:

$$PERF_{it} = \alpha + \beta_1 LEAD_{it} + \beta_2 IDPFR_{it} + \beta_3 BDSZ_{it} + \beta_4 FMLY_{it} + \beta_5 FRGN_{it} + \beta_6 DOM_{it} + \beta_7 FMGT_{it} + \beta_8 FMBD_{it} + \beta_9 LEV_{it} + \beta_{10} ASST_{it} + \beta_{11} IND_{it} + \varepsilon_{it}$$

where:

- PERF_{it}: performance of firm i in year t.
- LEAD_{it}: board leadership structure of firm i in year t.
- IDPFR_{it}: the representation of independent directors of firm i in year t.
- BDSZ_{it}: size of board of firm i in year t.
- FMLY_{it}: controlling family ownership of firm i in year t.
- FRGN_{it}: foreign blockholder ownership of firm i in year t.
- DOM_{it}: domestic blockholder ownership of firm i in year t.
- FMGT_{it}: controlling family involvement in management of firm i in year t.
- FMBD_{it}: controlling family involvement on the board of firm i in year t.
- LEV_{it}: leverage of debt of firm i in year t.
- ASST_{it}: size of firm i in year t.
- IND_{it}: industry group of firm i in year t.

The model includes several control variables such as leverage, firm size and industry. The agency literature suggests that leverage represents an external governance

mechanism, which is related to agency cost. Harris and Raviv (1991) argue that the debtholder is more likely to monitor the firm's operation in order to secure their investment. They contend that the evidence consistently supports the view, noting the importance of debt in mitigating agency conflict. In support of this view, the debt covenant hypothesis suggests that debt could be used as a bonding device, which reduces management control over free-cash flow and the incentive to commit job consumption (Jensen, 1986).

Firm size has been quoted as having important implication on firm's performance and control. Lehman and Weigand (2000) find that firm size negatively relates to firm performance which may result from organizational inefficiency. Dehaene, De Vuyst and Ooghe (2001) suggest that firm size relates to the importance of outside directors while the work of Klein (1998) reveals that the boards of larger US firms have more outside directors with business relations. A firm's industry reflects the nature of business that potentially affects the pattern of performance. For example, the financial industry is subject to more regulation and therefore exhibits a different business operation to a manufacturing firm. Barnhart, Marr and Rosenstein (1994) argue that firm performance might vary across industry systematically, while O'Dwyer (2003) suggests that the type of industry demonstrates a significant relationship with disclosure practices.

Chapter 6.4

Sample Construction

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6.5. Definition of Terms and Measurement

6.5.1. Performance

Firm performance is of prime importance to corporate governance research as it serves as an indicator of the effectiveness of a governance mechanism. Within the agency relationship, performance measurement provides the contracting parties with a basis for designing a mutually agreed contract that allows them to govern the firms (Ghalayani & Noble, 1996). Therefore, a performance measure might drive the behaviour of agents in the contracting environment that determines the organizational outcome (Otley, 2007). However, firm performance is a complex construct that reflects the multidimensional value creation of a firm's operation (Carton & Hofer, 2006).

Although firms might employ various alternative performance measures, Neely (2007) believes that the widely used performance indicator still relies on a financial-based concept that could be differentiated as either being a market-based or an accounting-based measure⁶⁹. Market-based performance relies on an efficient capital market in valuing the firm's share price and that directly reflects shareholder's wealth. Market

law (2nd degree, vertical); a brother- or sister-in-law (2nd degree, horizontal); and a husband or wife of a brother- or sister-in-law (2nd degree, horizontal), and (b) family relationship by descent: a parent or child (1st degree, vertical); a grandparent or grand child (2nd degree, vertical); a sibling (2nd degree, horizontal)

⁶⁹ See, for example, Dalton et al. (1998), Dalton et al. (1999), Rhoades, Rechner and Sundaramurthy (2000).

measures could be seen as a response to the shortcomings of accounting-based measures that has been argued as being incapable of fully reflecting the agency cost associated with the contracting environment (Wiwattanakantang, 2001; Carton & Hofer, 2006). However, a market-based measure might be a noisy indicator as it contains an investor's perception of performance. Hermalin and Weisbach (2003) argue that such a measure refers to the future expectation that might significantly diverge from actual firm performance. In other words, market perception merely reflects "...what investors say they would do, not what they actually do" (Heracleous, 2001, p.166).

An accounting-based measure refers to the accounting information disclosed by the firm that has been verified by an external auditor in order to assess its accordance with generally accepted accounting principles. However, several studies indicate that the accuracy of accounting information might be endogenously driven by various factors. Fan and Wong (2002) conclude that the pattern of ownership determines the magnitude of the earning response coefficient, a proxy for accounting earning informativeness, while Warfield, Wild and Wild (1995) find a significant relationship between managerial ownership of US firms and the informativeness of accounting earnings. The work of Rajan and Zingales (1998) reveals a positive relationship between accounting earnings and economic performance, suggesting that accounting numbers might properly reflect the actual performance of the firm. However, the emerging markets face a serious problem of transparency and disclosure as a consequences of ownership structure and ineffective board monitoring (Patel, Balic & Bwakira, 2002) that leads to the prevalence of earnings management (Fan & Wong, 2002; Bhattacharya, Daouk & Welker, 2003).

Studies investigating the relationship between board composition and firm performance might utilize six financial-based indicators such as Return on Asset (ROA), Return on Equity (ROE), Earning per Share (EPS), profit margin, market value of share and market to book value. The significance of the relationship between board composition and firm performance has been claimed as being sensitive to the performance definition that leads to the lack of consensus regarding the most suitable indicators of firm performance within the accounting-based measures domain (Dalton et al., 1998). This view implies

the importance of using various accounting-based measures of firm performance in investigating the relationship between board composition and firm performance.

A meta-analysis by Rhoades, Rechner and Sundaramurthy (2000) find that market to book value⁷⁰ and accounting return are consistent measures of firm performance. However, their work reveals that the interaction effect between outsider directors and accounting measures shows that accounting measures produce a more consistent relationship between board composition and firm performance as compared to those of market-based performance indicators. Therefore, this study will use ROA as the main performance indicator and ROE as an alternative performance indicator. ROA is defined as the ratio of earnings before interest, extraordinary items and taxes, to total assets. ROE is defined as the ratio of earnings before interest, extraordinary items, and taxes, to common equity. In addition, the work of Joh (2003) prevents this study from using market return and market-to-book value as performance indicators although such indicators have been quoted as robust measures⁷¹. Specifically, it is argued that using market-based indicators is inappropriate in emerging countries, where illiquid and thin trading activities result in the absence of an efficient form of capital market.

6.5.2. Outside Director and Leadership Structure

In the earlier literature, the operational definition of independent directors varies across studies. Rhoades, Rechner and Sundaramurthy (2000, p.79) suggest that "...there are four definitions of inside directors (and by exclusion, outside director)". The first definition refers to the employee, while the second definition adds former employees to the list. The third definition refers to 'other business relationship' such as a firm's lawyer or consultant, while the fourth definition includes a director who is appointed by the Chief Executive Officer (CEO). The latest studies consistently refer to the affiliation

⁷⁰ Although using market-based theoretically justifiable, however, In Indonesia there is a problem with the substantial absent day of trading of approximately 40% of total listed company in December 2002. The market to book value has been widely adopted as performance measures particularly in emerging market (Goyal & Yamada, 2004; Arslan & Karan, 2006), where such a measure relies on the market value of assets, debt, and equity. However, a discussion with official of JSX reveals that the data of such market value is unavailable in Indonesia that prevents the study to use market to book value as performance measure.

⁷¹ See for example Rosenstein and Wyatt (1990).

of directors to management in defining the independent director that covers the employment and other forms of business relationship.

In a related distinction, Bhagat and Black (2002) present three types of directors: insider, affiliated, and independent director. Insider directors are persons who are currently officers of the company. Affiliated directors are persons who are the relative of officers, persons who are likely to have a business relationship with the company such as investment bankers and lawyers, or persons who were officers in the recent past. Independent directors are outside directors without such affiliation aside from their directorship. However, Lukviarman (2004) argue that the concept of “directors’ affiliation” in Indonesia should refer to the controlling owners as this country is characterized by ownership concentration and a controlling owner versus minority shareholders agency conflict. Consistent with this view, the JSX officially defines independent directors as “...individuals without any affiliation with management, directors, controlling owners and do not serve as commissioners in other affiliated firms (interlocking director)⁷². Therefore, it is plausible to rely on the Jakarta Stock Exchange regulation in defining independent directors.

Following previous work, this study starts out with the assumption that the level of board independence is related to the observable board characteristics such as the representation of outside directors and the leadership structure (Hermalin & Weisbach, 1998; 2003). The representation of outside directors is measured using their proportion of the total number of directors, treated as a continuous variable. An alternative measure is proposed by dividing the sample into a dichotomous scale based on the above and below average which captures the sharp differences in staffing philosophies (Baysinger & Butler, 1985). Using family as the unit of analysis, a family member of controlling owners serving as board chairperson has been argued as creating a combined leadership

⁷² See SE-03/PM/2000, Kep-315/BEJ/062000, and Kep-339/BEJ/07-2001 art C.2. An interview with a JSX officer reveals that an independent director is a director without any affiliation with controlling owners. Persons who have a business relationship with a company such as bankers, lawyers, and person who were officers in the recent past considered as non-independent directors since they are likely to be affected by management decisions. He noted that JSX has a discretion regarding any dispute of interpretation of these regulations.

board. Accordingly, leadership structure is measured using a nominal scale that takes one if the board chairperson is an independent director, two if the board chairperson is an affiliated director and three if the board chairperson is a family member of controlling owners.

6.5.3. Controlling Owners

In most economies, corporate ownership is concentrated in a group of individuals who are related by blood or marriage (La Porta et al., 1999). Such a characteristic has been quoted as offering the rationale for using the family, instead of individuals, as the unit of analysis. This framework relies on the assumption that family members of controlling owners share the same interest and therefore will pursue collective actions in the contracting environment. Claessens, Djankov, and Klapper (2003) argue that this framework portrays the real control of the firm by family through the shareholdings of family members. Accordingly, this view treats indifferently the individual shareholding of one family member and the aggregate shareholding of all of family members. For example, Claessens et al. (2002, p.2746) note that “We do not consider ownership by individual family members to be separate, and we use total ownership by each family group—defined as a group of people related by blood or marriage—as the unit of analysis”. In other words, the aggregate shareholdings of members of a controlling family are treated identically to a single person in the framework where individuals serve as the unit of analysis. This view suggests that, in most economies outside the US and the UK, controlling owners refers to the family, rather than of individuals.

La Porta et al. (1999) use a 20% shareholding as a cut-off for differentiating between family-controlled firms and non family-controlled firms as such level carries sufficient voting rights that enables the holders to influence management decisions. Although, Lemmon and Lins (2003) have stressed the importance of disentangling cash-flow and voting rights associated with substantial shareholdings, there is a high incidence of governance research relying on cash-flow rights in defining ownership concentration by the largest shareholders. Roosenboom and van der Goot (2005), Krivogorsky (2006) and Cho and Kim (2007) suggest that control distribution might refer to the cash-flow right

whenever such distribution does not serve as the main variable of interest. Following previous work, this study relies on cash flow rights in defining the controlling shareholder ownership as such ownership is treated as a moderating variable. Specifically, this study defines controlling owners as the largest shareholder with at least 20% shareholding of corporate common shares. The controlling shareholder ownership is defined as the proportion of shares owned by the controlling family to total outstanding shares.

6.5.4. Blockholders

In the governance literature, blockholder refers to external shareholders with, at least, 5% corporate ownership although such a cut-off point might vary across studies⁷³. Such a level of ownership has been claimed as granting shareholders the incentive to monitor management and sufficient voting power to influence management decisions (Shleifer & Vishny, 1997). Accordingly, the presence of blockholders might serve as a governance mechanism that helps to alleviate the agency problems. However, Dherment-Ferere, Köke and Renneboog (2001) suggest that the type of blockholders might have an important impact on their monitoring effectiveness as different types of blockholders might have different power and incentive to monitor management. They distinguish the blockholders into specific groups such as financial institutions, family, company and state.

Complementary to the type, the role of blockholders as a governance mechanism depends on the institutional setting in which the firms operate. In Asian economies, blockholders are more likely to collude with controlling owners which exacerbates the agency problem (Faccio, Lang & Young, 2001). Consistent with this view, the OECD (2003) argues that the prevalence of the interlocking family is a salient feature of East Asian firms. This suggests that the family blockholders are less likely to play a significant monitoring role and implies that the benefit of blockholder monitoring might be expected whenever such blockholders are non-family or financial institutions without any affiliation with controlling owners. Accordingly, this study defines blockholder as

⁷³ See, for example, Heflin and Shaw (2000), Sangsoo and Song (1995), Agrawal and Mandelker (1990).

non-family shareholders, independent financial institutions or the state, with at least 5% shareholding. Foreign and domestic blockholder's ownership is measured as the proportion of shares owned by blockholders to total outstanding shares.

6.5.5. Controlling-Family Involvement in Management and on the Board

Controlling owners of Indonesian listed firms commonly appoint their family members to serve in management ADB (2000) and on the board (Tabalujan, 2002). Using the family as the unit of analysis, the individual shareholding of one family member has been argued as identical to the aggregate shareholding by all family members. This approach implies that the family members of controlling owners serving in management and on the board have identical interests as their family. Accordingly, such appointments might create an entrenchment effect as the higher aggregate shareholding by the controlling family provides their family members with sufficient voting power to insulate them from any disciplinary mechanisms. The entrenched management (Morck, Shleifer & Vishny, 1988) and board (Bebchuk & Cohen, 2005; Faleye, 2007) have been claimed as negating the effectiveness of governance systems although such entrenchment might be achieved through various arrangements.

Studies elaborating the entrenchment effect refer to the aggregate shareholding of the insiders in defining the level of entrenchment. This view hinges upon a specific setting where the management and the board consist of hired professionals without sufficient individual corporate ownership. However, as previously mentioned, the management and the directors who are family members of controlling-owners have been argued as having identical shareholding to their family ownership, implying that aggregating such ownership might overstate the figure. Moreover, Lukviarman (2004) argues that it is extremely rare to observe remuneration packages with stock options in Indonesia, suggesting that hired-professional insiders are less likely to have corporate ownership. This view indicates the importance of using the alternative proxy of insider entrenchment. Accordingly, this study relies on the ratio of family members of

controlling owner serving in management and on the board to the total number of management team and directors⁷⁴.

6.6. Statistical Method

This study mainly uses Ordinary Least Square (OLS) regressions for hypothesis testing. The regression analysis is constrained by several assumptions such as normality, multicollinearity, homoscedasticity, and linearity. Normality distribution is determined using the coefficient of its skewness and kurtosis. The data are normally distributed if the standard skewness and kurtosis are within ± 1.96 and ± 3 respectively. Multicollinearity refers to the existence of a high correlation between particular independent variables that may exist whenever the correlation coefficient exceeds 0.80 (Gujarati, 1995). Homocedasticity refers to the statistical model with "...a series of uncorrelated, purely random errors, ε , which are assumed to be normally distributed with mean zero and constant variance, σ^2 " (Aczel, 2005, p.461). According to Gozali (2007), the Park test might detect the presence of heteroscedasticity whenever the coefficient of estimates is significant at conventional level.

Linearity is an inherent issue that plagues studies investigating the relationship between the proportion of independent directors and firm performance (Hermalin & Weisbach, 2003). However, empirical work arrives at an inconclusive approach about what best addresses this issue and accordingly offers various approaches. Baysinger and Butler (1985) divide independent director representation into three discrete categories that reflect the sharp differences in board staffing philosophies. Block (1999) decomposes the sample into deciles, while Postma et al. (1999) adopts quadratic terms in order to overcome such problems. In a related issue, Morck, Shleifer, and Vishny (1988) prefer to use a piece-wise approach in their study investigating the association between managerial ownership and firm performance. Following previous work, linearity issues will be addressed by using a quadratic term, piece-wise, and discrete groupings of the proportion of independent directors.

⁷⁴ The same measurement approach is also used by Yeh (2005).

Another important issue within governance studies is the endogeneity problem that complicates the interpretation of the results (Börsch-Supan & Köke, 2002; Drobetz, 2003). To address this issue, some studies employ lagged data (Dherment-Ferere & Renneboog, 2000; Durnev & Kim, 2005) and two stages least squares (Lehman & Weigand, 2000; Black, Jang & Kim, 2006). Following previous work, this study will use lagged data and two stages least squares to address the endogeneity issue. However, empirical studies have proposed different models concerning the main and instrumental variables⁷⁵. This finding implies that researcher discretion is more likely to apply in this circumstance.

6.7. Summary

This study relies on the proposition that monitoring by the board of directors potentially determines the behaviour of contracting parties within the firm. This proposition is consistent with the deterministic view of the positivist paradigm. Accordingly, this study chooses positivism as its ontological choice and relies on the deterministic assumption of the real world where reality could be broken down into particular segments. The epistemological choice borrows from an objective approach implying that the hypotheses derived from underlying theory are subject to empirical test.

The sample consists of 190 firms listed on the JSX as of 2002 excluding financial institutions. Data of variables of interest are extracted from various sources. A research model is derived from agency theory predicting that a board composition is related to firm performance. The study addresses the empirical issue within governance research namely: the interdependence, linearity and endogeneity issue. As summarised in Table 4, the dependent variable is firm performance, measured using ROA and ROE. Independent variables are board composition (proportion of independent directors, leadership structure, and board size), ownership structure, and control variables. The next chapter provides descriptive statistics of variables of interest while the following chapter presents empirical tests regarding the association between dependent and independent variables.

⁷⁵ See for example Mak and Li (2001), Mak and Roush (2000) and Rediker and Seth (1995).

Table 4: Operationalisation of the Research Variables

Variables	Acronym	Measure	Source
Dependent Variable			
Return on Assets	ROA	The ratio of earnings before interest, extraordinary items and taxes to total assets	ICMD
Return on Equity	ROE	The ratio of earnings before interest, extraordinary items, and taxes to common equity	ICMD
Independent Variables			
Board leadership structure	LEAD	Dummy variable that takes 1 if the board chairperson is an independent director, 2 if the board chairperson is an affiliated director and 3 if the board chairperson is a family member of controlling owners.	AR, JSX list, PPLC, and PRO
Independent directors	IDPFR	Independent directors as a proportion of total number of directors	AR, JSX list
Controlling family ownership	FMLY	Common shares owned by a controlling family as a proportion of total outstanding common shares.	AR, PPLC, PRO
Foreign blockholder ownership	FRGN	Common shares owned by foreign investors as a proportion of total outstanding common shares.	ICMD, PPLC
Domestic blockholder ownership	DOM	Common shares owned by domestic blockholders as a proportion of total outstanding common shares.	ICMD, PPLC
Controlling family involvement in management	FMGT	The family members of controlling-owners serving in management as a proportion of total number of managers	AR, PPLC, and PRO
Controlling family involvement on the board	FMBD	The family members of controlling-owners serving on the board as a proportion of total number of directors	AR, PPLC, and PRO
Control variables			
Leverage	LEV	The ratio of leverage to total assets	ICMD
Size	ASST	Natural log of total assets	ICMD
Industry	INDT	The two-digit JSX industry classification	ICMD

Chapter 7: Descriptive Statistics

7.1. Introduction

In the previous chapters, the research design and hypotheses development were discussed. It was proposed that corporate governance, in general, and board structure in particular, determine the outcome of the firm. However, the association between board composition and organizational outcome might be contingent upon firm characteristics. As such, this chapter discusses the sample characteristics in order to provide a deeper understanding of Indonesian listed firms and the justification as to whether the association between board composition and firm value is applicable to the sample. This chapter starts with the comparison between population and sample characteristics. The next sections discuss the firm and governance characteristics. The last section summarizes the discussion.

7.2. Population and Sample

As presented in Table 5, the initial sample comprises 330 firms which fall into 35 industries. Financial institutions and non-financial institution consist of 56 and 274 firms respectively. There are 21 exit-entry firms during 2000 and 2002 while 40 firm's data are missing from the databases. This last figure confirms the difficulties experienced by other research in gathering publicly available information about Indonesian listed firms. The standardized residual values of 23 firms are beyond the range of ± 3.3 and therefore these firms are treated as outliers and deleted from the sample. The final sample consists of 30 industries comprising 190 firms, which represents 58% of total listed firms.

Table 6 presents the industry distribution of the final sample and its comparison to the initial sample. The financial institution category (banking, credit agencies, securities, and insurance) is the highest contributor to the initial sample (17%) while construction, fabricated metal products, machinery, communication, and holding companies are the lowest. The final sample consists mostly of manufacturing industries (72%) and the remaining 28% are engaged in wholesale and trade, property, transportation service, communication, hotel and service, holding and investment companies, and others. Fifty

percent of the final sample consists of the top seven industries (property, food and beverages, automotive, plastics and glass, chemicals, metals, and transportation).

Table 5: Sample Construction

Initial sample:	
Firms listed on Jakarta Stock Exchange as of 31/12/2002	330
Less:	
Financial institutions:	
Bank	22
Credit agencies	12
Securities	12
Insurance	10
	56
Non-financial institutions	274
Less:	
Entry and exit firms during 2000 – 2004	21
Surviving firms during 2000-2004	253
Less:	
Missing data firms	
Missing ICMD database	8
Missing annual report	19
Missing PPLC and PRO database	13
	40
Available sample	213
Less:	
Outliers	23
Final sample	190

Bottom ten industries provide 15% of the final sample. Although the machinery industry is absent from the final sample, this industry only consists of two firms (0.3% of the total population and 0.4% of non-financial institutions) and therefore it is reasonably expected that the exclusion affects the sample representation insignificantly. The table shows that the distribution of firms by industry demonstrates a relatively similar pattern between initial and final samples, offering assurance that the final sample represents population characteristics.

Table 6: Comparison between Initial Sample and Final Sample

N o	Industry	Initial Sample		Final Sample	
		N	%	N	%
1	property	37	11.21	21	14.29
2	food and beverages	21	6.36	16	10.88
3	automotive and allied product	18	5.45	14	9.52
4	plastic and glass	15	4.55	8	5.44
5	chemical and allied	8	2.42	7	4.76
6	metal and allied	12	3.64	7	4.76
7	transportation service	8	2.42	7	4.76
8	wholesale, retail, trade	14	4.24	7	4.76
9	pharmaceutical	11	3.33	6	4.08
10	apparel and other textile	16	4.85	5	3.40
11	agriculture	6	1.82	4	2.72
12	animal	8	2.42	4	2.72
13	mining	11	3.33	4	2.72
14	paper and allied	5	1.52	4	2.72
15	tobacco	3	0.91	3	2.04
16	lumber food	5	1.52	3	2.04
17	adhesive	4	1.21	3	2.04
18	cable	6	1.82	3	2.04
19	electronic and office equipment	4	1.21	3	2.04
20	consumer good	4	1.21	3	2.04
21	construction	2	0.61	2	1.36
22	cement	3	0.91	2	1.36
23	stone, clay, glass, and concrete product	5	1.52	2	1.36
24	communication	2	0.61	2	1.36
25	holding and investment companies	2	0.61	2	1.36
26	textile mill	10	3.03	1	0.68
27	fabricated metal product	2	0.61	1	0.68
28	photographic equipment	3	0.91	1	0.68
29	hotel and service	7	2.12	1	0.68
30	other	20	6.06	1	0.68
31	machinery	2	0.61		0.00
32	banking	22	6.67		0.00
33	credit agencies	12	3.64		0.00
34	securities	12	3.64		0.00
35	insurance	10	3.03		0.00
		330	100	147	100.00

7.3. Sample Characteristics

The descriptive statistics of all independent variables are presented in Table 7, displaying firms' characteristics (age, asset, and leverage), board characteristics (independent director, leadership and board size) as well as ownership characteristics

(controlling family ownership, foreign and domestic blockholders and controlling family involvement in the board and management). The table reveals that Indonesian listed companies are characterized by having lower assets, higher levels of leverage, and being younger firms. The statistics also exhibit a large disparity between the minimum and maximum value for all firm characteristics variables.

Table 7: Descriptive Statistics of Listed Firms in Indonesia*

	Mean	min	max	Std
Firms characteristics				
ASST ^a	2,269	34.85	49,311	5,513
LEV	0.713	0.024	5.109	0.561
INDT	16.813	1	35	8.912
Ownership and control characteristics				
FMLY	57.739	0.000	99.380	25.371
FRGN	11.357	0.000	96.600	24.076
DOM	2.534	0.000	49.380	9.883
FMBD	0.302	0.000	1.000	0.237
FMGT	0.300	0.000	1.000	0.270
Board characteristics				
LEAD	2.142	1.000	3.000	0.912
IDPFR	0.378	0.000	0.750	0.111
BDSZ	4.337	2.000	10.000	1.794

*Refer to Section 6.3 and Table 4 for abbreviations.

^a in billion Rupiah (IDR 10,000 = 0.9681 USD as of 31 December 2002)

7.3.1. Firms Characteristics

Mean and median values of total assets, as a proxy for firm size, are IDR⁷⁶ 2,658.23 billion and 956.61 billion respectively which indicate the disparity between the mean and median values. Moreover, the maximum and minimum values display a substantial range. The asset of the largest firm (PT. Indah Kiat Pulp and Paper, Tbk) is IDR 49,310 billion and the smallest company (PT Lion Mesh Prima, Tbk) is IDR 34.85 billion. As presented in Table 8, the assets of 153 firms (80% of the sample) are below the mean value and only 37 firms (20% of final sample) are higher than the average value. The smallest size group (assets less than IDR 1,000 billion) consists of 76 firms representing

⁷⁶ IDR = Indonesian Rupiah, the local currency of Indonesia

39% of total sample while 9 firms (5% of final sample) exhibit assets of more than IDR 10,000 billion, which is much higher than the mean and median values. These figures indicate that the size of Indonesian listed firms is relatively small.

Table 8: Distribution of Firm by Size

No	Firm Size ^a	N	%
1	Assets ≤ 500	74	38.95
2	500 < Assets ≤ 1,500	54	28.42
3	1,500 < Assets ≤ 2,500	29	15.26
4	2,500 < Assets ≤ 3,500	9	4.74
5	3,500 < Assets ≤ 4,500	6	3.16
6	4,500 < Assets	18	9.47
		190	100.00

^a in billion Rupiah (IDR 10,000 = 0.9681 USD, as of 31 December 2002)

The mean and median of leverage are 67.40% and 59.53% respectively, which are slightly higher than Lukviarman (2004) found. The minimum leverage is 2.21% (PT. Cipto Jaya Kontrindoreksa) and the highest is 510.65% (PT Prasadha Aneka Niaga) suggesting that some listed firms exhibit negative equity. These figures indicate that the financing patterns of Indonesian listed firms rely heavily on leverage rather than equity, and thus support the findings of Claessens, Djankov and Xu (2000) noting the prevalence of highly leveraged firms in East Asian countries. Table 9 further confirms the excessive reliance on external financing by Indonesian listed firms.

Table 9: Distribution of Firm by Leverage

No	Leverage ^a	N	%
1	Leverage ≤ 30%	28	14.74
2	30% < Leverage ≤ 50%	42	22.11
3	50% < Leverage ≤ 70%	47	24.74
4	70% < Leverage ≤ 100%	44	23.16
5	100% < Leverage	29	15.26
		190	100.00

^a leverage is defined as total liabilities/total asset

Firms with leverage of less than 50% number 70 representing 37% of the sample. The remaining 62% of the sample fall into a category with leverage of more than 50%, where 29 firms (15% of the sample) are technically insolvent as these firms demonstrate leverage which is more than 100%. These figures suggest that insolvency problems, associated with higher leverage, are faced by most Indonesian listed companies. The

ADB (2001) claims that, prior to the economic crisis in late 1998, Indonesian listed firms were engaged in excessive borrowing of foreign currency without sufficient hedging. This leads to the significant increase of leverage subsequent to the IDR depreciation resulting from the crisis.

Table 10 presents a comparison of firm characteristics between listed firms in Indonesia and other economies reported in selected previous research. A comparison by country of firm size shows this to be the smallest in Indonesia, followed by Malaysia, Singapore, Taiwan and New Zealand, while UK and the US exhibit the largest firm size.

Table 10: Comparison of Firm's Characteristic between Indonesia and Other Countries

Study	Period	Country	Assets ^a	Lev ^b
Schellenger, Wood and Tashakori (1989)	1986	US	1,361	- ^c
Villalonga and Amit (2006)	1994-2000	US-larger firm	9,510	-
Gugler and Yurtoglu (2003)	1991-1996	Germany	736 (7.041) ^f	-
Hossain, Prevost and Rao (2001)	1991-1997	New Zealand	372 (638)	0.41
Yeh and Woidtke (2005)	1998	Taiwan	510 (16,394)	0.42
Daily and Dalton (1994)		US	-	0.47
Vafeas and Theodorou, (1998)	1994	UK	-	0.17
Mak and Kusnadi (2005)	1999	Singapore	431	0.45
		Malaysia	305	0.44
Cho and Kim (2007)	1999	Korea	893 (1,064,262)	-
this study (2009)	2002-2004	Indonesia	276 (2,658,229)	0.71

^a average value. Figure is in US\$ million or its equivalent. The original amount in local currency is presented in the bracket.

^b average value. Leverage is defined as total liabilities divided by total assets

^c not reported

^f the original figure is stated in natural log form

The average size in Indonesia is one fifth of that for US small firms and one fiftieth of larger US firms (Fortune 500). The proportion of debt to asset of Indonesian firms displays the highest percentage; as much as one and a half times that of the US and Taiwan and three times larger than UK firms. Given that leverage almost entirely

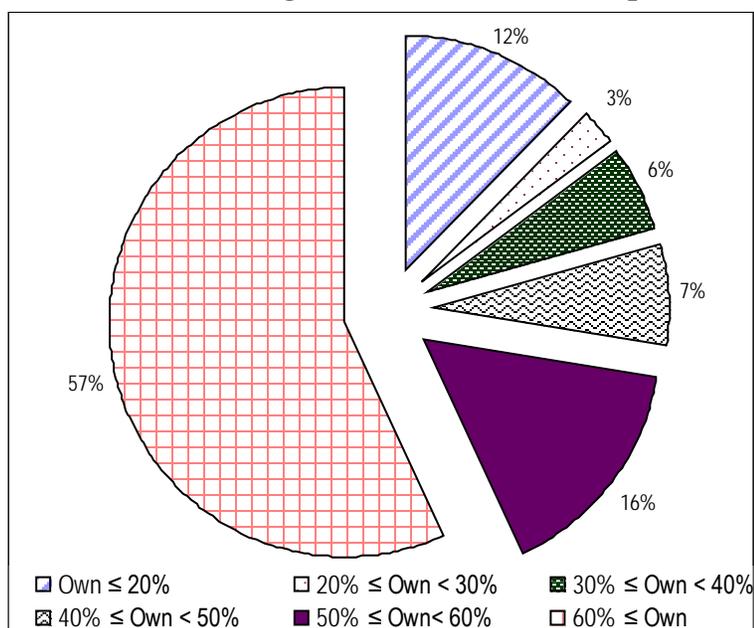
comprises bank borrowing, this figure supports the notion that the financing pattern could be classified into a bank-oriented system.

7.3.2. Ownership and Control Characteristics

7.3.2.1. Ownership Characteristics

Indonesian listed firms are typified by a high ownership concentration, lower fraction of unrelated blockholders, and higher involvement of controlling family in management and on the board of directors. As presented in Table 7, the mean shareholding by domestic controlling owners is 57% ranging from 0% (minimum) to 98% (maximum)⁷⁷. The prevalence of ownership concentration by controlling owners is demonstrated in Figure 3.

Figure 3: Frequency Distribution of Firms by Controlling Shareholders Ownership



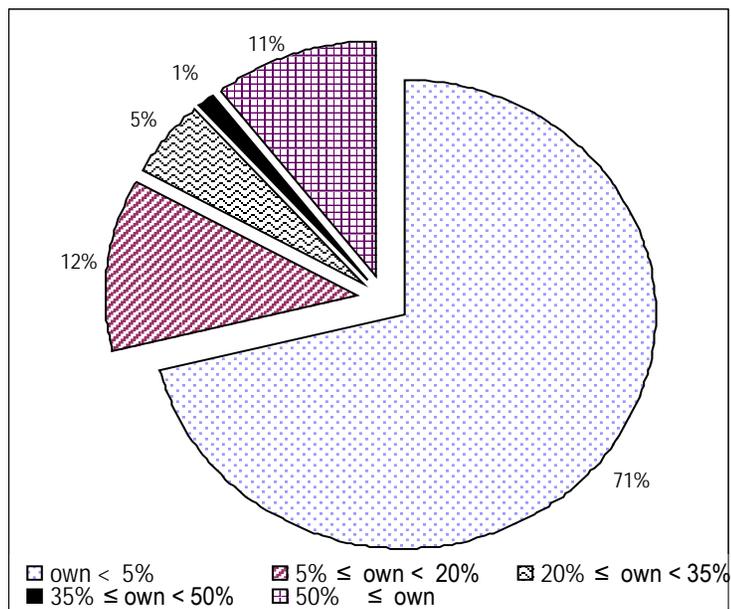
Local controlling owners hold more than 50% of corporate shares in 103 firms (70% of the sample). Controlling owners are absent in only 21 firms, representing 12% of total

⁷⁷ In all sample, the immediate owner of the firm is another company of particular business groups owned by the same controlling owners. This ownership structure, so-called pyramidal ownership, is consistent with the finding of Claessens et al (2000, 2002). In some cases, the firm is jointly owned by several families who form a partnership to control the firm. However, this joint ownership is a floating coalition, instead of a permanent coalition, where the partnership changes in other firms.

sample. This description is consistent with Lukviarman (2004) documenting the ownership concentration by controlling family in 70% of Indonesian listed firms during 1994 to 2000. The presence of controlling shareholders is evident in 88% of the sample (167 firms). Diffused ownership, where minority investors cumulatively own more than 80% of corporate shares, is found in only 5 firms representing 3% of the total sample. This figure confirms the work of Claessens, Djankov, Lang (2000) revealing the prevalence of concentrated ownership firms and that only small numbers of Indonesian firms have dispersed ownership structure.

The average foreign investor's shareholding is 11 % ranging from 0% (minimum) to 96% (maximum). However, as presented in Figure 4, only one third of firms exhibit the presence of foreign shareholders while such shareholders are absent in most listed firms (135 firms representing 71% of the sample).

Figure 4: Frequency Distribution of Firms by Foreign Ownership

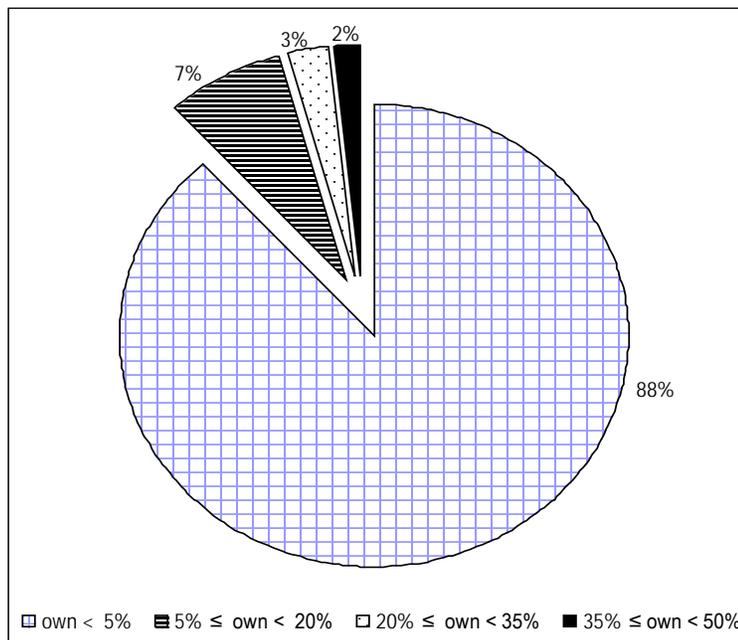


Foreign investors own 50% or more of the corporate shareholding in 20 firms representing 11% of the sample. Further analysis reveals that 5% of the listed firms are jointly owned by foreign and domestic-investors with 50% shareholding or higher.

According to ADB (2001), such coalition provides foreign investors with access to the local market and political connections.

As presented in Table 7, the mean shareholding by domestic blockholders is 2.5% ranging from 0% (minimum) to 49% (maximum). However, Figure 5 shows that domestic blockholders are found in only 11% of the sample (22 firms). Of these firms, the highest frequency falls into the 5% to 20% ownership category.

Figure 5: Frequency Distribution of Firms by Domestic Blockholder



Eighty-eight percent of the sample (168 firms) displays an absence of domestic blockholders suggesting that the absence of external large shareholders, who are independent of controlling shareholders, is the salient feature of listed firms in Indonesia.

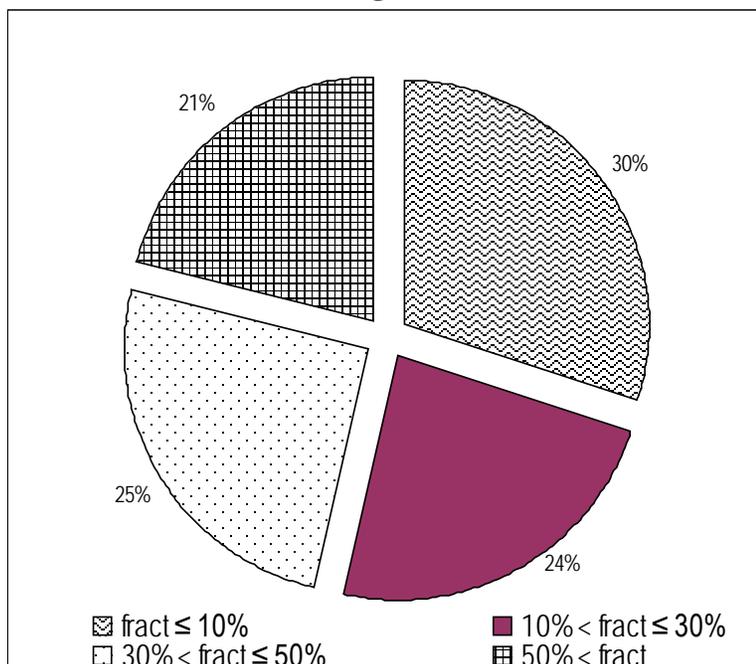
The previous descriptions reveal that Indonesian listed firms exhibit a higher degree of ownership concentration by a controlling family. From a legal perspective, La Porta et al. (1999) note that concentrated ownership is more likely to be observed in economies where property right protection is ineffective. Given that the investor protection

provided by the Indonesian legal system is among the lowest around the world (see section 4.2), ownership concentration in Indonesia could be seen as a means for majority shareholders to facilitate contract enforcement as the shareholders are forced to rely less on the state for such enforcement. Another plausible explanation is advanced by Claessens et al. (2002). According to these authors, concentrated ownership could be seen as an entrenchment device to secure the ability of controlling owners to expropriate minority shareholders who are unable to effectively challenge majority control.

7.3.2.2. Controlling-Family Involvement in Management and on the Boards

Another important feature of corporate control of Indonesian listed firms is the involvement of a controlling family in management and on the board. The level of owners' involvement in management, as measured by the proportion of family members on the management team to overall management size, varies across firms. On average, management consists of 36% of controlling-family members and this number ranges from 0% as the lowest to 100% as the highest. The distribution of firms by owner's involvement in management is presented in Figure 6.

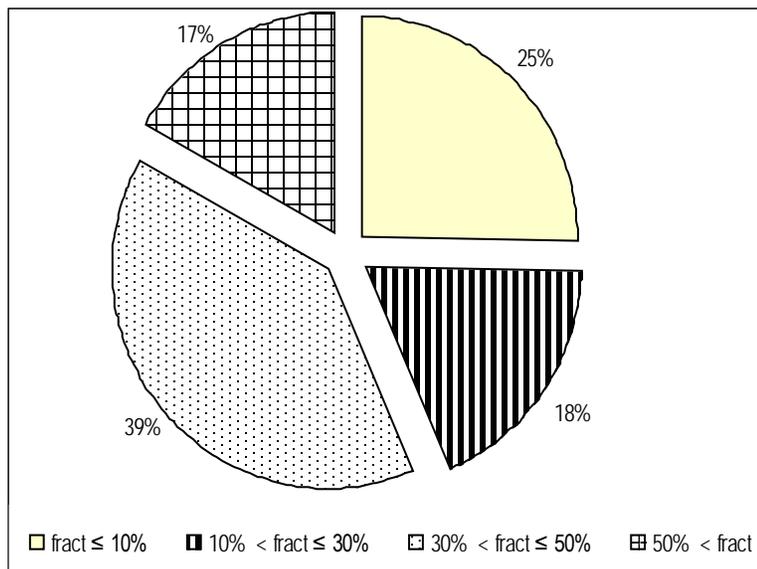
Figure 6: Frequency Distribution of Firms by the Fraction of the Family Member of Controlling Owners in Management



The figure shows that owners' involvement in management is observed in 133 firms representing 70% of the sample. The family members of controlling owners occupy 10% to 50% of management teams in 93 firms (49% of the sample). Family-dominated management exists in 40 firms or one fifth of the sample as the management teams comprise more than 50% of controlling family members. These descriptions are consistent with ADB (2002) claiming that controlling owners' involvement in management is prevalent in Indonesian listed firms.

On average, the board of directors comprise 30% of controlling family members. However, the proportion of family members serving as directors varies across firms, ranging from 0% as the minimum and 75% as the maximum fraction. These figures indicate that family members dominate the boards of directors in several companies, whereas, on the other side, family members are absent from the boards of some firms. The distribution of firms by owners' involvement on the board is presented in Figure 7.

Figure 7: Frequency Distribution of Firms by the Fraction Of the Family Member of Controlling Owners on The Board



The absence of family members on the board is found in 48 firms (25% of the sample) while the remaining 142 firms (75% of the sample) have family members of controlling

owners on the board. Figure 7 reveals that the fraction of family members on boards mostly falls in the 30%-50% range. Family dominated boards exist in 32 firms (17% of the sample) as the family members occupy more than 50% of board seats. These figures confirm the work of Lukviarman (2004) regarding the prevalence of owners' involvement in the boards of Indonesian listed firms.

Table 11 shows firm distribution by controlling family involvement in either top management or the in board of directors or both. On most occasions, controlling-family members are involved in both the board of directors and in the top management team. The absence of controlling owners on either the board or in the management team is found in only 39 firms (21% of the sample) while the remaining sample displays the presence of owner's involvement on either the board or in the management team or both.

Table 11: Frequency Distribution of Firms by Family Involvement in Management and in the Board

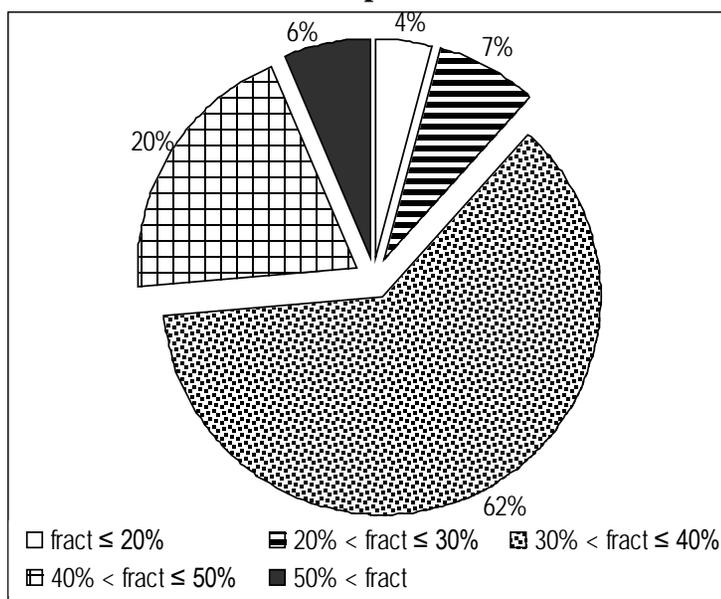
		Board of Directors		Total
		Not Involved	Involved	
Management	Not Involved	39 21%	17 9%	56 29%
	Involved	9 5%	125 66%	134 71%
		48 25%	142 75%	190 100%

Controlling owners serve in either the management or on the board in 9 firms (5% of the sample) and 17 firms (9% of the sample) respectively. Although owners' involvement in the board of directors is higher than in management, this difference is statistically insignificant. The family members of controlling owners actively participate on both the board of directors and in management in 125 firms representing 66% of the sample. Overall, these descriptions confirm the notion that Indonesian listed firms exhibit a higher degree of owners' involvement in corporate control (ADB, 2000).

7.3.2.3. Board Characteristics

The average proportion of independent directors to total number of directors is 38% ranging from 0% as the minimum to 75% as the maximum proportion. This indicates that the boards of several companies comprises insider directors entirely while, on the other hand, some firms have outsider dominated boards. Figure 8 presents the distribution of firm by the proportion of independent directors to board size.

Figure 8: Frequency Distribution of Firms by the Fraction of Independent Directors

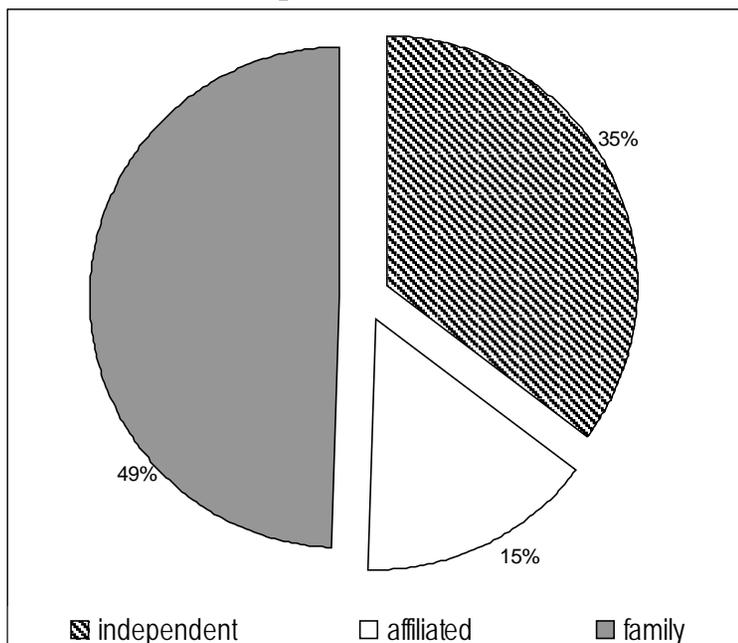


The proportion of outsider directors serving on the board falls mostly in the 30% to 40% range. Insider dominated boards (where the fraction of independent directors is less than 50%) is observed in 145 firms representing 76% of the sample. The boards of 45 firms (24% of the sample) comprise at least 50% of outsider directors. Of this group, outsider majority boards (where the proportion of independent directors is 50% or more) are found in 12 firms (6% of the sample) and one firm has outsider supermajority board (where the board consists of 75% or more of independent directors). In 168 firms (88% of the sample) the fraction of outside directors is 33% or higher suggesting that most of Indonesian listed firms have complied with the JSX regulation which state that the

proportion of independent directors of listed firms should be at least one third of total number of directors.

Indonesian listed firms exhibit the existence of family members of the controlling owners serving as a board chairperson. As presented in Figure 9, the board's chairperson of 94 firms, representing 49% of the sample, is held by a family member of the controlling owners. This figure is much higher than independent and affiliated board chairpersons. An independent board chairperson is found in 67 firms (35% of the sample) and the remaining 29 firms (16% of the sample) have an affiliated chairperson.

Figure 9: Frequency Distribution of Firms by the Board Leadership



On average, the boards of Indonesian listed firms consist of 4.3 directors. As presented in Figure 10, the smallest size group (3 directors or less) comprises 87 firms representing 46% of the sample, where most of them (77 firms or 41% of the sample) have 3 directors on their board. The largest size group (more than 7 directors) comprises 21 firms representing 12% of the sample. Board size of 76 firms (40% of the sample) is higher than the average number of directors. The boards of 5 firms (4% of the sample) comprise 10 directors, the maximum board size of Indonesian listed firms. The

minimum board size consists of 2 directors suggesting that listed firms in Indonesia have met the requirement stating that publicly listed corporations should have at least 2 directors serving on the board⁷⁸.

Figure 10: Frequency Distribution of Firms by Board Size

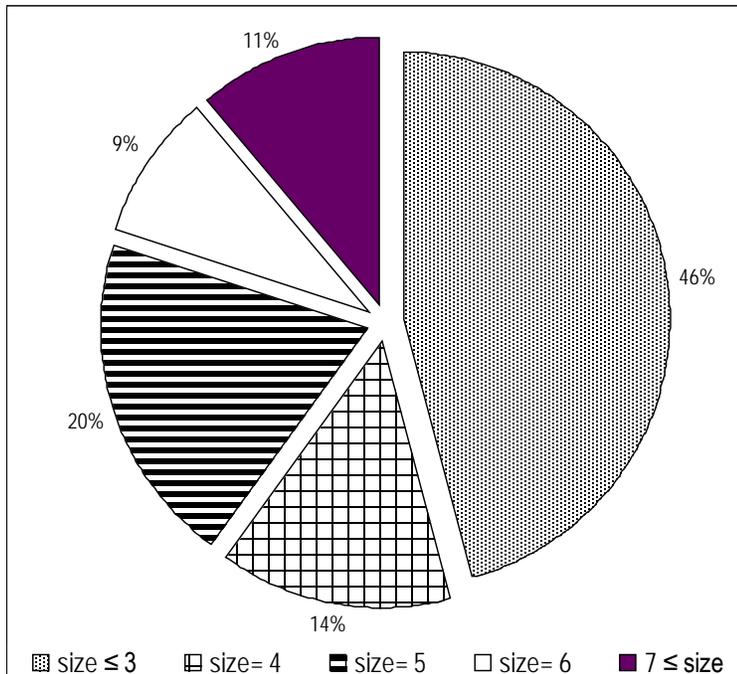


Table 12 presents comparisons by country of board size and composition. The descriptions show that board structure varies across countries with the US firms demonstrating the largest board size and outsiders' representation. Developed countries have larger boards than those in developing economies. Two-tier countries (Indonesia and Taiwan) have fewer directors than their one-tier counterparts. The boards of firms in developed economies consist of a larger proportion of independent directors than those in developing countries. The number of directors in Indonesian firms is lower than developed economies (European and US countries). The board size in Indonesia is one third that of US firms, two thirds for Belgium and UK, and half that of Canadian firms.

⁷⁸ Company Law 1995 art 94 (2) and articles 79 (2)

Table 12: Comparison of Board Characteristics between Indonesia and Other Countries

Study	Country	Size	The Average Proportion of Outside Directors (%)	The Average Proportion of Inside Directors (%)
			-	52
Baysinger, Kosnik and Turk (1991)	US	-	-	41
Yeh and Woitke (2005)	Taiwan	2.1	-	47
Schellenger, Wood and Tashakori (1989)	US	9.5	65	-
Vafeas and Theodorou (1998)	UK	8.1	33	-
Erickson et al. (2005)	Canada	10.7	69	-
Block (1999)	US	12.3	40	-
Hossain, Prevost and Rao (2001)	New Zealand	6.6	57	-
Rosenstein and Wyatt (1997) ^a	US	12.1	52	39
Bhagat and Black (2002)	US	11.5	60	-
Matolcsy, Stokes and Wright (2004)	Australia	6.6	67	-
Dehaene, De Vuyst and Ooghe (2001)	Belgium	8.4	67	-
Barnhart, Marr and Rosenstein (1994)	US	12.4	61	-
Mak and Kusnadi (2005)	Singapore	7.3	36	-
	Malaysia	7.4	34	-
Heaney (2007)	Hong Kong	10.1	-	-
	Malaysia	8.6	-	-
	Philippines	9.5	-	-
	Singapore	7.5	-	-
	Thailand	12.6	-	-
Nowland (2008)	Hong Kong	-	30	-
	Indonesia	-	37	-
	Malaysia	-	38	-
	Singapore	-	52	-
	Thailand	-	32	-
Hanifa and Hudaib (2006)	Malaysia	7.9	59	-
This study (2009)	Indonesia	4.4	38	-

^a the remaining proportion is treated as the grey directors

The proportion of independent directors in Indonesia is also among the smallest as compared to the developed countries. Outsider representation in Indonesia is two thirds that of US, half that of Belgium and Canada, and two thirds that of Taiwan. Surprisingly, the fraction of outsider directors in Indonesia is higher than in the UK. However UK firms seem to adopt a separated board leadership in order to compensate for the lower outsider directors' representation⁷⁹. This structure enables the firms to maintain board independence with fewer outsider directors. Compared to UK firms, Indonesia is more

⁷⁹ See, for example, Faccio and Lasfer (2000) and Dahya and McConnell (2005).

likely to have controlling owners serving as a board chairperson while at the same time appoints fewer outsider directors. Accordingly, the board structure of an Indonesian firm is less likely to be independent of the majority owners which enable them to completely control the firm's operation through their domination of the board structure.

Compared to developing countries in East Asian, where similar institutional settings may exist; the board size in Indonesia and Taiwan is among the smallest with Thailand and Hong Kong exhibiting the largest number. East Asian countries show an equal fraction of independent directors except in Singapore. However, when board size is taken into account, the figures tell a completely different story. On average, the boards consist of 3 independent directors in Hong Kong, 3 in Malaysia, 4 in Singapore, 4 in Thailand, and only 1 in Indonesia. These figures indicate that the absolute number of outside directors in Indonesian firms is the smallest among Asian countries. The low number arguably make it difficult for independent directors to influence board's decision because of their inability to overcome board specific tasks through actively participating in board committees such as audit, investment, and finance.

7.4. Summary

This chapter presents the descriptive statistics of variables of interest. It was documented that Indonesian firms are characterized by relatively small firm size as measured by total assets and highly leveraged. The governance characteristics are typified by small board size, lower outsider representation, and the prevalence of controlling family involvement in management and on the board. Such involvement leads to a combined leadership, although Indonesia adopts a two-tier board system. The concentrated ownership by controlling shareholder and the smaller number of institutional investors are the common features of ownership structure in Indonesian listed firms. The next chapter presents empirical testing linking the board composition, ownership structure and firm performance.

Chapter 8: Empirical Analysis

8.1. Introduction

In the previous chapters, the theoretical and empirical issues, hypotheses, and descriptive statistics of variables of interest were discussed. The previous chapter reveals that Indonesian listed firms are characterized by a lower proportion of independent directors, a smaller board size, and the prevalence of family member of the controlling-owner sitting as a board chairperson, ownership concentration in the hand of controlling families, the smaller number of independent large shareholders, and the controlling-family involvement in management and on the board. This chapter discusses the empirical testing undertaken to investigate the relationship between board composition and firm performance. This chapter begins by discussing the classical assumption of Ordinary Least Square (OLS) regressions. The next sections discuss univariate and multivariate tests, as well as the robustness checks and the limitations of the study. The last section summarizes the discussions.

8.2. Assumptions

In the main, this study uses OLS multivariate regressions for hypothesis testing. The regression analysis is constrained by several assumptions such as normality, multicollinearity, linearity and homoscedasticity. Normality of the distribution is determined using the coefficients of skewness and kurtosis. The data is normally distributed if the standard skewness and kurtosis are within ± 1.96 and ± 3 respectively.

Table 12 presents the normality test of variables of interest based on skewness and kurtosis values. As the outliers have been deleted, all variables of interest show a normal distribution except for foreign and domestic blockholders. Multicollinearity exists whenever the independent variables are highly correlated with each other. Aczel (2005) suggests that the Variance Inflation Factor (VIF) and the Pearson correlation matrix are the common methods to detect the presence of multicollinearity. According to Gujarati (1995), multicollinearity may exist whenever the correlation coefficient among particular independent variables exceeds 0.80. The Pearson correlation matrix, presented in Table 13, reveals that the correlations coefficient between independent variables are

relatively low, indicating that there is no presence of multicollinearity problem. In all models, the VIF value is far below 6. The VIF and Pearson correlation scores thus confirm that the multicollinearity assumption is not violated.

Table 13: Skewness and Kurtosis Coefficients of Variables of Interest

	Skewness Statistic	Std. Error	Kurtosis Statistic	Std. Error
LEAD	-0.335	0.194	-1.705	0.385
IDPFR	0.034	0.194	2.266	0.385
BDSZ	1.318	0.194	1.611	0.385
FMLY	-0.949	0.194	0.226	0.385
FRGN	1.877	0.198	2.177	0.394
DOM	1.916	0.204	1.696	0.406
FMBD	0.344	0.194	-0.539	0.385
FMGT	0.682	0.194	-0.302	0.385
LEV	-0.625	0.194	2.904	0.385
ASST	0.496	0.194	0.269	0.385
INDT	0.200	0.194	-1.267	0.385
ROA02	1.003	0.194	2.081	0.385

Homocedasticity refers to the statistical model with a series of uncorrelated, purely random errors, ε , which are assumed to be normally distributed with mean zero and constant variance, σ^2 (Aczel, 2005). According to Gozali (2007), Park tests might detect the presence of heteroscedasticity whenever the coefficient of estimates is significant at conventional levels. The results of Park tests reveal that none of the coefficients of the estimates reaches such significance levels and thus the Homocedasticity assumption is not violated. Homocedasticity is further confirmed by residual plots presented in Appendix 4.

8.3. Correlations

Table 14 presents the correlation of variables of interest. The correlation coefficients between independent variables are relatively low indicating that there is no presence of multicollinearity problem. However, controlling-family shareholding (FMLY) and foreign ownership are highly correlated and therefore this study avoids taking these variables simultaneously in one specification.

Table 14: Pearson Correlation Coefficient of Variables of Interest

This table presents pairwise correlations of variables. LEAD is a categorical variable equal to 1 for independent directors serving as board chairperson, 2 for affiliated director, and 3 for a family member of controlling owners. IDPFR is the proportion of independent directors to total number of directors. BDSZ is the total number of directors. FRGN is the proportion of common share held by foreign investor. FMLY is the proportion of common share held by controlling family. FMBD is the proportion of family members of controlling owners serving on the board to total number of directors on the board. FMGT is the proportion of family members of controlling owners serving in top management to total number of managers. LEV is natural log of total liabilities to total assets. ASST is the natural log of total assets. INDT is the 2-digit code of JSX industry classification. ROA02 is the ratio of earnings before interest, taxes and extraordinary items to book value of assets as of 31 December 2002. ROA03 is the ratio of earnings before interest, taxes and extraordinary items to book value of assets as of 31 December 2003.

	1	2	3	4	5	6	7	8	9	10	11
1 LEAD	1.000										
2 IDPFR	-0.166 **	1.000									
3 BDSZ	-0.120	0.016	1.000								
4 FMLY	0.449 ***	-0.099	-0.019	1.000							
5 FRGN	-0.420 ***	0.005	0.079	-0.749 ***	1.000						
6 DOM	-0.062	0.193 *	-0.009	0.017	-0.043	1.000					
7 FMBD	0.517 ***	-0.035	-0.273 ***	0.433 ***	-0.463 ***	-0.131 *	1.000				
8 FMGT	0.362 ***	0.076	-0.201 ***	0.278 ***	-0.390 ***	-0.071	0.631 ***	1.000			
9 LEV	0.117	-0.022	0.069	0.130 *	-0.220 ***	-0.135 *	0.247	0.162 **	1.000		
10 ASST	-0.099	0.017	0.449 ***	-0.091	0.029	-0.071	-0.164 **	-0.112	0.243 ***	1.000	
11 INDT	-0.024	0.007	0.002	0.095	-0.125 *	0.007	0.022	-0.015	-0.047	-0.013	1.000
12 ROA02	-0.219 ***	-0.077	0.081	-0.269 ***	0.323 ***	-0.052	-0.310 ***	-0.298 ***	-0.284 ***	0.134 *	-0.079

* significant at 0.1 level

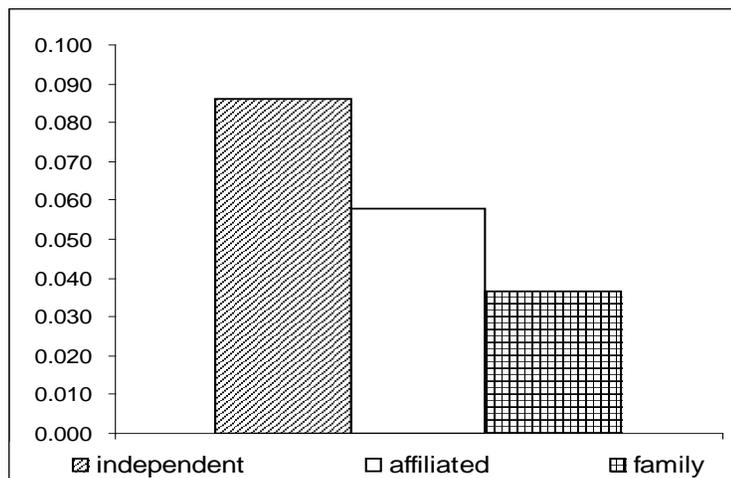
** significant at 0.05 level

*** significant at 0.01 level

The correlation coefficient between leadership structures (LEAD) and the proportion of outside directors (IDPFR) is significantly negative, suggesting that affiliated leadership boards have smaller numbers of independent directors. This finding is in contrast with UK firms that adopt independent leadership to compensate for higher numbers of insider directors in order to maintain board independence. Thus, Indonesian listed firms are less likely to compensate for the presence of a higher number of insider directors with independent board leadership. Consequently, such a composition enables the controlling family to effectively control the board as insider directors dominate the board and at the same time hold the board chairperson position.

Leadership structure is found to have a significant negative correlation with firm performance (ROA02), suggesting that independent leadership is related to superior firm performance. Figure 11 presents firm performance for different leadership structures. The figure shows that firms with an independent board chairperson exhibit superior performance as compared with those of family or affiliated. The performance differences between independent, affiliated and family are significant at the 1% level.

Figure 11: Average Return on Asset by Leadership Structure

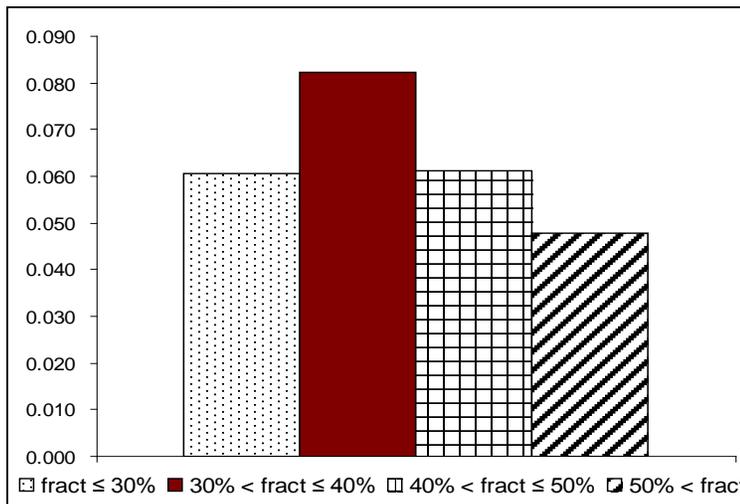


Leadership structure is negatively correlated with foreign shareholding (FRGN) and is positively correlated with controlling-family ownership. These suggest that a higher foreign ownership is associated with independent leadership while a higher controlling-

family shareholding is related to affiliated leadership. Leadership structure is also found to have a positively significant correlation with family involvement in the management team (FMGT) and involvement on the board of directors (FMBD). These indicate that affiliated leadership is associated with higher numbers of controlling-family members serving in top management teams and on the board of directors.

The correlation coefficient between the proportion of independent directors and firm performance is insignificant. Figure 12 presents the means of ROA for different levels of the fraction of independent directors serving on the board.

Figure 12: Average Return on Assets by the Fraction of Independent Director

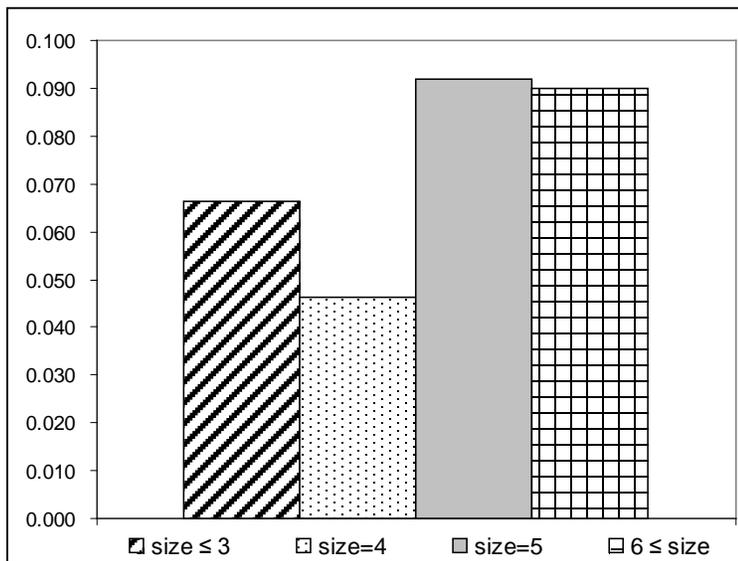


The figure reveals a non-monotonic relationship between the fraction of independent directors and firm performance. Consistent with this finding, Bhagat and Black (1999; 2002) argue that the relationship between board composition and firm performance is more likely to be non-linear. The direction of such a pattern is consistent with the finding of Block (1999) who documents the inverted-U shaped pattern for US firms. The proportion of independent directors is positively correlated with domestic independent large shareholders (DOM), suggesting that higher shareholding by domestic blockholder is associated with a higher fraction of outside directors. As leadership structure is negatively correlated with foreign shareholdings, taken together, these findings imply

that domestic and foreign blockholders pursue different strategies in overcoming agency problems. While domestic large shareholders rely on the proportion of outside directors, foreign blockholders choose to select independent leadership as a monitoring device.

The association between board size and firm performance is insignificant. This finding is inconsistent with the work of Yermack (1996), Eisenberg, Sundgren and Wells (1998), Mak and Kusnadi (2005) and Coles, Daniel and Naveen (2008), documenting a significant relationship between board size and firm performance. Figure 13 presents the association between different levels of board size and firm performance. The figure confirms the inconsistent association between board size and firm performance.

Figure 13: Average Return on Asset by Board Size



Board size (BDSZ) is significantly correlated with firm size (ASST). The direction of such an association is positive, suggesting that larger firms have more directors serving on the board⁸⁰. According to Daily and Dalton (1992), more assets are associated with more complex decisions and accordingly require more people to deal with them. However, the association between firm size and outsider representation is insignificant. Given that outsider directors reflect a board monitoring ability, this association indicates that the Indonesian firms are more likely to prevent scrutiny from an internal governance

⁸⁰ The correlation between assets and management size (not reported here) has a similar pattern.

mechanism. This supports the work of Fan and Wong (2002) claiming that firms in East Asian countries prefer to operate in greater secrecy in order to secure rent-seeking activities, irrespective of the firm size. Another plausible explanation is advanced by Hutchinson and Gull (2004) claiming that larger assets represent the potential for growth opportunity. They argue that growth firms require more informed directors, which are represented by insider directors, in order to enable the board to focus on the advisory role and to provide management with more discretion to pursue investment opportunities.

Foreign shareholders are more likely to invest in older firms as the correlation coefficient between these variables is significantly positive. Further, foreign ownership has a negative correlation with leverage, indicating that less leveraged firms have higher foreign shareholdings. Given that firms in Indonesia face similar financial difficulty (the average proportion of debt to total assets is more than 60%), this suggests that foreign shareholders invest in better managed companies. One explanation of this association is that foreign shareholders induce better corporate governance by actively exercising continuous scrutiny, which in turn produces better organizational outcomes. Another plausible explanation is that foreign shareholders simply pursue cherry-picking strategies.

Foreign ownership is also positively correlated with firm performances, indicating that firms with higher foreign shareholding exhibit superior performance. The correlations between these two variables are significant at the .01% levels. Foreign ownership has a negative correlation with family involvement in the management team and the board of directors. Given that such involvement creates a higher level of entrenchment effect, this figure indicates that foreign shareholders are more likely to invest in the democratic firm where disciplinary action might work⁸¹. This figure is consistent with Alpay et al. (2005) of the Turkish dataset. They find that firms with foreign investment have more independent, more experienced, and less insider dominated boards, suggesting that foreign investors actively participate in governance mechanisms.

⁸¹ See Gompers, Ishii, Metrick (2003) for further discussion of dictatorship-firm and democracy-firm.

The correlation between controlling-family ownership (FMLY) and leadership structure is significantly positive at the 1% level. Family ownership is also positively associated with the proportion of controlling-family members serving in the top management team (FMGT) and on the board of directors (FMBD). These findings suggest that family-controlled firms are more likely to have affiliated leadership and higher involvement in management and on the board. The positive sign indicates that leadership structure and family involvement in either management team or on the board of directors are complement to the family ownership and accordingly could be seen as the control-enhancing mechanisms.

Controlling-family ownership is positively correlated with leverage (LEV), indicating that the family-controlled firms are characterized by higher leverage. Controlling-family ownership exhibits a negative correlation with firm performance, suggesting that higher family ownership is associated with lower firm performance. Further, the family involvement in the top management team and on the board of directors also displays negative association with firm performance. This finding offers supportive evidence that excessive control-enhancing mechanisms are more likely to create entrenchment effects, rather than alignment effects, and thus enable a controlling family to commit expropriation, which is detrimental to minority investor wealth.

8.4. Multivariate Data Analysis

8.4.1. The Effect of Board Composition on Return on Assets

Agency theory posits that board independence would be positively related to firm performance, where the board independence is determined by the leadership structure and the proportion of independent directors serving on the board (Zahra & Pearce, 1989). Therefore, agency theory predicts that an independent leadership and a higher fraction of independent directors would have a positive association with firm performance. To test these propositions, Table 15 reports the results from OLS regressions linking board composition and firm performance measured by return on assets. The F-values for all specifications are significant at the 1% level. In the absence of control variables, the R^2 ranges between 0.069 and 0.108.

Table 15: Cross-sectional OLS Regression of ROA on Board Composition, Controlling-Family Shareholding, Controlling-Family Involvement in Management and on the Board, Blockholders Ownership and Control Variables (N=190)

The equation is $PERF_{it} = \alpha + \beta_1 LEAD_{it} + \beta_2 IDPFR_{it} + \beta_3 BDSZ_{it} + \beta_4 FMLY_{it} + \beta_5 FRGN_{it} + \beta_6 DOM_{it} + \beta_7 FMGT_{it} + \beta_8 FMBD_{it} + \beta_9 LEV_{it} + \beta_{10} ASST_{it} + \beta_{11} INDT_{it} + \varepsilon_{it}$. The dependent variable is ROA 2002, defined as the ratio of earnings before interest and taxes to book value of assets as of 31 December 2002. LEAD is a categorical variable equal to one for board chairperson being held by independent directors, two affiliated directors and three the family member of controlling owners. IDPFR is the proportion of independent directors to total number of directors. BDSZ is the total number of directors. FMLY is the proportion of the immediate shareholding of controlling-family to total outstanding common shares. FMGT is the proportion of the family members of controlling owner serving in management to total number of managers. FMBD is the proportion of the family members of controlling owner serving on the board to total number of directors. FRGN is the proportion of foreign shareholding to total outstanding common shares. DOM is the proportion of shareholding by unrelated domestic block holders to total outstanding common shares. FMGTxFMBD is the interaction term of FMGT and FMBD. LEV is natural log of total liabilities to total assets. ASST is the natural log of total assets. INDT is the 2-digit code of JSX industry classification.

		1	2	3	4	5	6	7
(Constant)		0.132 ***	0.176 ***	0.155 ***	0.140 ***	-0.013	0.094***	-0.071
		3.699	4.218	3.756	3.983	-0.161	2.587	-0.878
LEAD	beta	-0.025 ***	-0.027 *	-0.030 *	-0.009	-0.004	-0.089	-0.007
	t-value	-3.343	-1.681	-1.915	-1.004	-0.414	-1.450	-0.775
IDPFR	beta	-0.094	-0.107 *	-0.073	-0.085	-0.071	-0.014*	-0.077
	t-value	-1.505	-1.725	-1.176	-1.381	-1.198	-1.704	-1.294
BDSZ	beta	0.003	0.003	0.001	0.000	-0.001	0.003	-0.002
	t-value	0.898	0.901	0.257	0.071	-0.277	-	-0.419
FMLY	beta	-	-0.001 ***	-	-	0.131	-	-
	t-value	-	-2.816	-	-	1.276	-	-
FMGT	beta	-	-	-0.084 ***	-	-0.103 **	-	-0.045
	t-value	-	-	-3.074	-	-2.085	-	-1.447
FMBD	beta	-	-	-	-0.106 ***	-0.061	-	-0.011
	t-value	-	-	-	-2.873	-1.071	-	-0.266
FRGN	beta	-	-	-	-	-	0.001***	0.001**
	t-value	-	-	-	-	-	3.563	2.137
DOM	beta	-	-	-	-	-	0.015	0.006
	t-value	-	-	-	-	-	0.736	0.294
FMGTxFMBD	beta	-	-	-	-	0.000	-	-
	t-value	-	-	-	-	-1.484	-	-
LEV	beta	-	-	-	-	-0.036 ***	-	-0.036 ***
	t-value	-	-	-	-	-3.683	-	-3.581
ASST	beta	-	-	-	-	0.012 **	-	0.013 **
	t-value	-	-	-	-	2.120	-	2.383
INDT	beta	-	-	-	-	-0.001	-	-0.001
	t-value	-	-	-	-	-1.122	-	-1.037
R2		0.069	0.103	0.110	0.108	0.225	0.131	0.224
R2-Adj		0.054	0.083	0.090	0.089	0.181	0.107	0.180
F		4.574	5.296	5.701	5.628	5.190	5.540	5.153
Sig.		0.004	0.000	0.000	0.000	0.000	0.000	0.000

*** significant at 0.01 level

** significant at 0.05 level

* significant at 0.1 level

Equation 1 reveals that leadership structure (LEAD) demonstrates a significant relationship with firm performance at the 1% significance level. The negative sign suggests that a separated leadership firm (independent directors serving as board chairpersons) outperforms a combined leadership firm (where the board chairperson is an affiliated director or family member of the controlling-owner) and therefore allows this study to accept Hypothesis 1a. This indicates that the independent leadership is more likely to mitigate agency problems as such leadership encourages a board monitoring role. According to Jensen (2000), the chairperson possesses the power and greater influence to organize board activities, which includes setting board meeting agenda, and independent leadership enhances the ability of the board to monitor management effectively. Another plausible explanation for this result is that higher performing firms might appoint outside directors as their board chairperson since this firm has more resources to adopt better governance (Heaney, 2007). The proportion of independent directors (IDPFR) is significantly related to firm performance in one of seven specifications, indicating that such a governance mechanism is an insignificant predictor of firm performance. Therefore, Hypothesis 1b is rejected. This result implies that an empirical test for Hypotheses 2b, 2d, 3b, 3d becomes irrelevant.

In all specifications, board size (BDSZ) is insignificantly related to the firm's performance across the years of observation, irrespective of the presence of control variables. However, the relationship is positive suggesting that a larger board size is favourable with regard to the firm performance. Although insignificant, this finding supports the view of Boone et al. (2007) who argue that a larger board size is related to organizational performance in the firm with an advisory need from the board. Moreover, it is inconsistent with the work of Yermack (1996) who documents that a smaller board size is associated with a higher firm value.

An important issue pertinent to the association between board composition and firm value is the interdependence among governance mechanisms, implying that the effectiveness of the board monitoring role is contingent upon the presence of other strong governance mechanisms (Rediker & Seth, 1995; Coles & Hesterly, 2000).

Shleifer and Vishny (1986) and Maury and Pajuste (2005) suggest that large shareholders might serve as governance mechanisms as they have both incentive and economic rationale to monitor management. Accordingly, the presence of large shareholders potentially affects the association between board composition and firm performance. To test this proposition, the study includes controlling owner's shareholding in the model. Column 2 displays the results of estimating the OLS regression of ROA on board composition, adding controlling-family ownership as an independent variable. The governance variables explain approximately 10% of cross-sectional variations in ROA.

Controlling-family shareholding (FMLY) is found to have a negative relationship with accounting performance at the 1% level of confidence. The negative sign suggests that firm performance is better with more diffused share ownership. This finding is inconsistent with Haniffa and Hudaib (2006) who documented a higher accounting performance in concentrated ownership of Malaysian listed firms. However, their work did not differentiate between controlling family and unrelated large shareholders' ownerships, which might confound their results. Leadership structure demonstrates significant relationship with firm performance at 10% significance level. The negative sign indicates that independent leadership remains beneficial in the presence of ownership concentration by a controlling family. However, as compared with the result of column 1, the level of significance of the relationship between leadership structure and firm performance decreases in the presence of a controlling-family shareholding. Therefore Hypothesis 2a is confirmed.

The fraction of independent directors becomes a significant predictor of firm performance at 10% significance level. Contrary to the prediction, the significance of outside directors is negative, suggesting that a higher fraction of independent directors is associated with lower firm performance. According to Hermalin and Weisbach (1998; 2003) the negative association might be driven by an endogenous effect of board appointment. Particularly, poor performing firms tend to appoint more independent directors to convince market participants that the company is aware of poor performance associated with higher agency problems. This pattern might also be driven by non-

linearity associations between the fraction of independent directors and firm performance (Baysinger & Butler, 1985), where the marginal cost of information property of additional outside directors severely outweighs its marginal benefit beyond a particular point.

However, the negative relationship between the representations of independent directors is found in two of seven equations indicating that the representation of independent directors on the board is an inconsistent predictor of firm performance. In specification 2, such a relationship is significant in the presence of controlling family ownership. In specification 6, the significance of such a relationship occurs when the corporate ownership by foreign blockholders is taken into account. The results suggest that the importance of the representation of independent directors in Indonesia is contingent upon the structure of corporate ownership. Although it might be disputed, the findings provide supportive evidence to the existence of interdependence among governance mechanisms. Another plausible explanation is related to the simultaneous effect of ownership structure and the nomination and appointment process of independent directors. Particularly, in the Indonesian context, the absence of regulation concerning the nomination and appointment process facilitates controlling owners to appoint independent directors that are less likely to challenge their control of the firm and thereby risk their private benefit of control. In other words, the absence of such a regulation enables controlling owners to appoint individual, who has a relationship with the controlling owners, to serve as independent director. Such an appointment might hinder the firm to appoint “truly” independent directors that prevents independent director to fulfil their monitoring responsibility. Therefore, independent directors might fail to deliver value improvement from monitoring action and leave the ex-ante poor performance of the firm unimproved. This argument suggests that in the Indonesian context, the representation of independent directors in Indonesia is more likely to be related to the ex-post poor firm performance.

Controlling owners of Indonesian listed firms typically appoint their family members to serve in management and on the board. Higher shareholding by the controlling family

implies that such involvement potentially creates managerial entrenchment problems advanced by Morck, Shleifer & Vishny (1988). Accordingly, such involvement might affect the effectiveness of the board's monitoring role and empirically negate the association between board composition and firm performance. To test this proposition, the study includes the proportion of controlling-family members serving in management and on the board into the equations.

Column 3 provides OLS regression results for firm performance on board composition and controlling-family involvement in management. In the absence of control variables, the governance mechanisms explain about 11% of the cross sectional variation in ROA. Family involvement in the management team (FMGT) is negatively related to firm performance at the 1% significance level, suggesting that better accounting performance is more likely to be found in the firms with lower numbers of controlling-family members serving in management. Given that shareholding by management of controlling-family is relatively high⁸², this result suggests that accounting performance would be lower whenever disciplinary action provided by the market for corporate control is ineffective in disciplining the larger fraction of the management team. The relationship between leadership structure and firm performance remains significant at the 10% level of confidence. However, as compared to the previous result (Column 1), the level of significance of the relationship between leadership structure and firm performance decreases in the presence of the controlling family in management. Therefore Hypothesis 3a is confirmed. The proportion of independent directors and board size remain insignificant predictors of firm performance. Thus, board size and the proportion of independent directors are confirmed as insignificant governance mechanisms, regardless of the family involvement in the management team.

Column 4 reports the results of multivariate OLS regressions of board composition on firm performance, adding family involvement on the board into the models. The governance variables explain about 11% of the cross sectional variation in firm

⁸² The average shareholding by controlling family is approximately 58% (see section 7.1), which is much higher than insider ownership reported by Morck, Shleifer and Vishny (1988).

performance. The presence of controlling-family involvement in the board (FMBD) is negatively related to firm performance. This relationship is significant at the 1% level, suggesting that such an involvement reduces firm performance. This pattern indicates that controlling-family involvement on the board is more likely to create an entrenchment effect, rather than an alignment effect, which can exacerbate agency problems. In the presence of controlling-family involvement in the board, leadership structures become insignificant. This finding indicates that the effect of leadership structure on firm performance disappears with the greater number of family members of the controlling owner serving on the board and therefore Hypothesis 3c is upheld. The result suggests that the power and greater influence of the board chairperson in organizing board activity becomes less significant whenever family members, who share the same personal interest with management, dominate the board. Board size and outside directors remain insignificantly related to firm performance.

Column 5 displays the results of estimating the OLS of firm performance on board composition, controlling-family ownership and controlling-family involvements in management and on the board, adding the interaction between controlling-family involvement in management and on the board of directors as an independent variable. The presence of family members of the controlling owner serving in management and on the board is negatively related to the firm performance, suggesting that such involvements discourage organizational outcomes. The interaction effect of both is insignificant. However, the positive sign suggests that family involvement in management is a complementary control device to such involvement on the board. This indicates that majority owners engage in excessive control-enhancing mechanisms that provide them with uncontested control. As compared to column 1, the significant association between leadership structures and firm performance disappears with the inclusion of the controlling-family involvement in management and on the board, suggesting that such involvements are more likely to affect the relationship between leadership structure and firm performance. Board size and the proportion of outside directors remain insignificant predictors of firm performance.

Maury and Pajuste (2005) suggest that unrelated large shareholders might serve as governance mechanisms that mitigate the agency problem associated with the presence of controlling owners. To test this proposition, column 6 presents OLS regression results linking board composition and independent large shareholders on firm performance. Board composition and independent large shareholders explain approximately 13% of the variation in firm performance. Foreign shareholding (FRGN) is positively related to firm performance at the 1% significance level. The positive sign suggests that higher foreign shareholding is associated with better firm performance. As the foreign investors tend to have substantial fractions of corporate ownership (see Section 7.3.2), this finding confirms the claim that such ownership provides them with the economic rationale to actively participate in monitoring management (Shleifer & Vishny, 1986). In a similar vein, La Porta et al. (2000) argue that such investors will demand a high standard of corporate governance in order to secure their investment, and consequently corporate governance of the host firms will be improved. This will reduce agency cost and enhance firm performance. Consistent with this result, Chibber and Majumdar (1999) find that substantial foreign ownership improves firm performance in Indian firms.

As compared to the previous result (Column 1), the inclusion of independent large shareholders into the specification lessens the significance of the association between leadership structure and firm performance. Accordingly, this result provides evidence supporting Hypothesis 2c. This effect is partly because of the significant correlation between foreign shareholding and independent leadership. This indicates that foreign investors are more likely to actively participate in the decision making process through choosing independent leadership as a governance mechanism.

8.4.2. Sensitivity Analysis

8.4.2.1. Measure of Firm Performance

According to Dalton, et al. (1998), the relationship between board composition and firm performance is sensitive to the measurement of firm performance. To address this issue, the study re-ran OLS regression analyses using return on equity (ROE) as the performance indicator. Table 16 presents OLS regression results linking board

composition on Return on Equity (ROE) as the proxy for firm performance. F-values of all specifications are significant at the 5 % level or lower except for equation 2.

Overall, Table 16 confirms the results of Table 15. In three of six specifications, leadership structure (LEAD) demonstrates a significant relationship with firm performance indicating that such a relationship is consistent across the measures of firm performance. The negative sign suggests that firm performance will be lower in the combined leadership firm (where the board chairperson's position is held by an affiliated director or a family member of the controlling owners), thus allowing this study to accept Hypothesis 1a. This result therefore provides supportive evidence that independent leadership is more likely to mitigate agency problems as such a leadership encourages board independence necessary for effective monitoring. The fraction of independent directors (IDPFR) demonstrates an insignificant relationship with firm performance and thus this result is unable to support Hypothesis 1b. Using ROE as the dependent variable, board size (BDSZ) remains an insignificant predictor of firm performance. However, the positive sign suggests that a larger board size is beneficial to firm performance.

Column 3 displays the OLS regression results of ROE on the board composition and family involvement in management. Board composition and family involvement in management explain 9% of the variation in firm performance. Family involvement in management is negatively related to firm performance at the 5% significance level, suggesting that higher numbers of controlling-family members serving on the management team is associated with lower firm performance. Leadership structure displays a negative and significant relationship with firm performance, suggesting that independent leadership might still be able to benefit the firms, regardless of the presence of family involvement in the management team. However, similar to Table 15, the level of significance of the relationship between the leadership structure and firm performance decreases with the presence of family involvement in management and therefore Hypothesis 3a is confirmed. The fraction of independent directors and board size demonstrates an insignificant association with firm performance.

Table 16: Cross-sectional OLS Regression of ROE on Board Composition, Controlling-Family Shareholding, Controlling-Family Involvement in Management and on the Board, Blockholders Ownership and Control Variables (N=172)

The equation is $PERF_{it} = \alpha + \beta_1 LEAD_{it} + \beta_2 IDPFR_{it} + \beta_3 BDSZ_{it} + \beta_4 FMLY_{it} + \beta_5 FRGN_{it} + \beta_6 DOM_{it} + \beta_7 FMGT_{it} + \beta_8 FMBD_{it} + \beta_9 LEV_{it} + \beta_{10} ASST_{it} + \beta_{11} IND_{it} + \varepsilon_{it}$. The dependent variable is ROE 2002, defined as the ratio of shareholder's equity to book value of assets as of 31 December 2002. LEAD is a categorical variable equal to 1 for board chairperson being held by independent directors, 2 affiliated directors and 3 the family member of controlling owners. IDPFR is the proportion of independent directors to total number of directors. BDSZ is the total number of directors. FMLY is the proportion of the immediate shareholding of controlling family to total outstanding common shares. FMGT is the proportion of the family members of controlling owner serving in management to total number of managers. FMBD is the proportion of the family members of controlling owner serving on the board to total number of directors. FRGN is the proportion of foreign shareholding to total outstanding common shares. DOM is the proportion of shareholding by unrelated domestic blockholders to total outstanding common shares. FMGTxFMBD is the interaction term of FMGT and FMBD. LEV is natural log of total liabilities to total assets. ASST is the natural log of total assets. IND is the 2-digit code of JSX industry classification.

		1	2	3	4	5	6	7
(Constant)		0.496 ***	0.493 ***	0.482 ***	0.486 ***	0.035	0.401 **	0.091
		2.874	2.815	2.831	2.878	0.102	2.174	0.256
LEAD	beta	-0.171 ***	-0.175 **	-0.111 *	-0.069	-0.044	-0.127 *	-0.031
	t-value	-2.787	-2.529	-1.711	-0.989	-1.079	-1.861	-0.768
IDPFR	beta	-0.248	-0.246	-0.159	-0.201	-0.042	-0.248	-0.096
	t-value	-0.914	-0.901	-0.591	-0.755	-0.156	-0.905	-0.355
BDSZ	beta	0.009	0.009	0.001	-0.003	-0.020	0.008	-0.018
	t-value	0.555	0.548	0.088	-0.196	-1.102		-0.970
FMLY	beta	-	0.000	-	-	0.002		
	t-value	-	0.135	-	-	1.447		
FMGT	beta	-	-	-0.287 **	-	-0.440 **		-0.378 *
	t-value	-	-	-2.504	-	-2.079		-1.684
FMBD	beta	-	-	-	-0.421 ***	-0.615 **		-0.506 *
	t-value	-	-	-	-2.940	-2.440		-1.941
FMGTxFMBD	beta	-	-	-	-	0.756 *		0.606
	t-value	-	-	-	-	1.715		1.309
FRGN	beta	-	-	-	-		0.002	0.000
	t-value	-	-	-	-		1.466	0.133
DOM	beta	-	-	-	-		0.027	0.008
	t-value	-	-	-	-		0.302	0.097
LEV	beta	-	-	-	-	0.027		0.031
	t-value	-	-	-	-	0.654		0.732
ASST	beta	-	-	-	-	0.035		0.035
	t-value	-	-	-	-	1.460		1.433
IND	beta	-	-	-	-	-0.002		-0.002
	t-value	-	-	-	-	-0.734		-0.571
R2		0.051	0.052	0.086	0.098	0.154	0.064	0.143
R2-Adj		0.035	0.029	0.064	0.076	0.102	0.036	0.084
F		3.054	2.281	3.930	4.555	2.944	2.281	2.442
Sig.		0.030	0.063	0.004	0.002	0.002	0.049	0.008

*** significant at 0.01 level

** significant at 0.05 level

* significant at 0.1 level

Column 4 displays the results of estimating OLS regression linking firm performance to board composition and controlling-family involvement on the board. In the absence of control variables, the governance variables explain approximately 10% of cross-sectional variation in ROE. Family involvement on the boards exhibits a significant negative relationship with firm performance at the 1% significance level. This result suggests that the family members of controlling owners serving on the boards discourage firm performance. In the presence of family involvement on the board, the relationship between leadership structure and firm performance becomes insignificant. As such, these results confirm Hypothesis 3c predicting that the association between leadership structure and firm performance is moderated by the presence of controlling-family members serving on the board. Consistent with the previous results of Table 15, board size and the fraction of independent directors remain insignificant predictors of firm performance.

Column 5 presents OLS regression results linking the board composition, controlling-family ownership, controlling-family involvement in management and on the board and its interaction term, control variables and ROE as the proxy for firm performance. The family involvement in management is negatively related to firm performance at the 5% significance level. Family involvement on the board also exhibits a negative relationship with firm performance at the 5% significance level. The interaction effect of both is significantly related to the firm performance at the 10% significance level. The positive sign of the interaction effect suggests that family involvement in management (on the board of directors) is a complementary control device to the involvement on the board of directors (in management). As the correlation between those variables is significant (see Section 8.3), this finding indicates the involvements in management and on the board could be seen as control-enhancing mechanisms of controlling owners.

Column 6 reports the results of cross-sectional OLS regression of ROE on board composition and blockholder ownership. Leadership structure demonstrates a significant relationship with firm performance while foreign and domestic blockholders are found to have an insignificant relationship with firm performance. However, in the presence of

unrelated large shareholders, the significance relationship between leadership structure and firm performance decreases, providing empirical support to upholding Hypothesis 2c. This result indicates that the importance of leadership structure as a governance mechanism is contingent to the presence of other governance mechanisms. Board size and the proportion of independent directors remain insignificantly related to firm performance.

8.4.2.2. Measures of Board Composition

The measures of board composition have been argued as affecting the empirical tests investigating the association between board composition and firm performance (Rhoades, Rechner & Sundaramurthy, 2000). To address such issues, this study re-ran the OLS regressions using the different measures of leadership structure and independent directors' representation. A nominal scale is used where 1 represents an independent director serving as the board chairperson and 2 otherwise. An alternative measure of the proportion of independent directors is proposed by dividing the proportion into three ranks using an ordinal scale based on the above and below average in order to better depict the differences in staffing philosophies (Baysinger & Butler, 1985). The value of independent directors is '0' if the boards consists of less than 30% independent directors, '1' if the proportion of independent directors ranges from 30% to 40%, and '2' if the board comprises more than 40% independent directors. Table 17 presents OLS regressions of ROA on the different measures of leadership structure and the representation of independent directors. In all specifications, F-values are significant at the 1% level except for equation 2. As compared with the previous related tests, the tables show insignificant differences in R^2 . Using different measures, leadership structure exhibits consistent and significant association with firm performance across equations. The negative sign suggests that an independent board chairperson outperforms family and affiliated leadership.

The representation of independent directors is found to have an insignificant relationship with firm performance, suggesting that the insignificant relationship is robust with different measures of the representation of independent directors. In all specifications,

board size demonstrates an insignificant relationship to firm performance. These results indicate that such relationships are robust with alternative measures of board composition.

Table 17: Cross-sectional OLS Regressions of ROA on Board Composition-Sensitivity Analysis of Board Composition Measures (N=190)

The equation is $PERF_{it} = \alpha + \beta_1 LEAD_{it} + \beta_2 IDPFR_{it} + \beta_3 BDSZ_{it} + \epsilon_{it}$. The dependent variable is ROE 2002, defined as the ratio of This table presents cross-sectional OLS regression of ROA on board composition. The dependent variable is ROA 2002, defined as the ratio of earnings before interest and taxes to book value of assets as of 31 December 2002. LEAD is a categorical variable equal to 1 for board chairperson being held by an independent director, 2 for affiliated directors and 3 if a family member of controlling owners. LEAD1 is a categorical variable equal to 1 for board chairperson being held by independent directors and 2 otherwise. IDPFR is the proportion of independent directors to total number of directors. IDPRANK is a categorical variable equal to 1 if the proportion of independent directors is lower than 30%, 2 if the proportion of independent directors ranges from 30% to 40% and 3 if the proportion of independent directors is higher than 40%. BDSZ is the total number of directors.

		1	2	3	4
(Constant)		0.160***	0.146***	0.150***	0.150***
	t-value	3.806	3.523	3.590	3.654
LEAD	beta	-0.047***	-0.045***		
	t-value	-3.200	-3.083		
LEAD1				-0.051***	-0.050***
				-3.498	-3.463
IDPFR	beta	-0.102		-0.094	
	t-value	-1.617		-1.496	
IDRANK	beta		-0.012		-0.016
	t-value		-1.155		-1.557
BDSZ	beta	0.003	0.003	0.003	0.003
	t-value	0.778	0.797	0.781	0.807
R2		0.064	0.058	0.072	0.073
Adj-R2		0.049	0.043	0.057	0.058
F		4.259	3.809	4.838	4.904
Sig		0.006	0.011	0.003	0.003

*** significant at 0.01 level

** significant at 0.05 level

* significant at 0.1 level

8.4.2.3. Non-linearity

This study adopts two techniques in order to capture the possibility of non-linear relationships between the proportion of independent directors and firm performance. The first is piece-wise linear regressions, which allow for two changes in the slope

coefficient on board composition⁸³. This study uses the following variables to estimate and report piece-wise linear regressions:

<i>BD30</i>	= proportion of outside directors if the proportion of independent directors <30%
	= 30% if the proportion of independent directors \geq 30%
<i>BD30-50</i>	= 0 if proportion of independent directors <30
	= proportion of independent directors minus 30% if $30\% \leq$ proportion of independent directors <50%
	= 20% if proportion of independent directors \geq 50%
<i>BD50</i>	= 0 if proportion of independent directors <50%
	= proportion of independent directors minus 50% if proportion of independent directors \geq 50%

For example, when the proportion of independent directors is equal to 45%, it would have $BD30=30$, $BD30-50=15$, and $BD50=0$. The 30% to 50% independent directors' level is used, for example, by Block (1999). Secondly, following Postma (1999), this study employs a quadratic term for board composition.

Table 18 reports the OLS regressions linking the board composition to firm performance using the piece-wise method (columns 1, 2 and 3) and a quadratic term for the proportion of independent directors (columns 4, 5 and 6). F-values of the models range from 2.93 to 3.212 and are significant at the 5% level. Leadership structure remains negatively related to firm performance at the 1% significance level. In all specifications, independent director are insignificantly related to firm performance. This result provides empirical support that the insignificant relationship between outsider director representations to the firm performance is not driven by non-linearity association. The failure to support the non-linearity hypothesis is consistent with the work of Postma (1999) and inconsistent with the US finding of Block (1999).

⁸³ Morck, Shleifer & Vishny (1988) also use this technique in order to capture the non-linear relationship between insider ownership and firm performance.

Table 18: Cross-sectional OLS Regression of ROA on Board Composition - Sensitivity Analysis of Non-linearity Issue (N=190)

The equation is $PERF_{it} = \alpha + \beta_1 LEAD_{it} + \beta_2 IDPFR_{it} + \beta_3 BDSZ_{it} + \epsilon_{it}$. The dependent variable is ROA 2002, defined as the ratio of earnings before interest and taxes to book value of assets as of 31 December 2002 (specifications 1 and 2), ROA 2003 (specifications 3 and 4) and ROA 2004 (specifications 5 and 6). LEAD is a categorical variable equal to one for board chairperson being held by independent directors, two being held by affiliated director, and three being held by the family member of controlling owners. IDPFR is the proportion of independent directors to total number of directors. BD30 is equal to proportion of outside directors if the proportion of independent directors <30% and equal to 30% if the proportion of independent directors $\geq 30\%$. BD3050 is equal to 0 if proportion of independent directors <30, equal to the proportion of the proportion independent directors minus 30% if $30\% \leq$ proportion of independent director <50% and equal to 20% if proportion of independent directors $\geq 50\%$. BD50 is equal to 0 if proportion of independent directors <50% and equal to the proportion of independent directors minus 50% if the proportion of independent director $\geq 50\%$. IDPQUAD is the quadratic term of IDPFR. BDSZ is the total number of directors.

		1	2
(Constant)		0.138 ***	0.147 ***
	t-value	2.813	2.682
LEAD	beta	-0.049 ***	-0.048 ***
	t-value	-3.329	-3.213
IDPFR	beta		-0.021
	t-value		-0.090
BD30	beta	0.000	
	t-value	-0.007	
BD3050	beta	-0.014	
	t-value	-0.073	
D50	beta	-0.025	
	t-value	-1.015	
IDPQUAD	beta		-0.104
	t-value		-0.363
BDSZ	beta	0.002	0.003
	t-value	0.491	0.732
R2		0.074	0.065
Adj-R2		0.049	0.045
F		2.935	3.212
Sig.		0.014	0.014

*** significant at 0.01 level

** significant at 0.05 level

* significant at 0.1 level

8.4.2.4. Endogeneity Issue

The previous discussion has revealed that board composition, particularly leadership structure, is significantly related to firm performance. However, literature suggests that the board is an endogenous institution determined by prior firm performance (Agrawal & Knoeber, 1996; Hermalin & Weisbach, 1998; 2003). For example, Börsch-Supan and Köke (2002) argue that firms might improve particular governance mechanisms in response to poor prior firm performance, suggesting that poor prior performance is

related to higher proportions of independent directors. By contrast, Nowland (2008) argues that particular governance improvements depend on the resources available to the firm. This argument implies that better prior firm performance is associated with higher representations of outsider directors. Nevertheless, those studies suggest that prior performance is an important predictor of the existing governance mechanisms adopted by the firms.

Although a theoretical ground is unavailable, there exists a consensus among empirical studies investigating the determinants of the board composition. Ownership structure, leverage and firm size might determine the proportion of outsider directors, while leadership structure has been argued as endogenously determined by ownership structure, leverage, firm size, and the proportion of outsider directors (Bathala & Rao, 1995; Rediker & Seth, 1995; Mak & Li, 2001). This is consistent with the Indonesian legal perspective stipulating that a director is nominated and directly appointed by shareholders at the annual general meeting with a simple majority and one-share one-vote rule⁸⁴. Therefore, the proportion of independent directors is expected to be related to the ownership structure, leverage, firm size and prior performance, while leadership structure is predicted to be determined by the proportion of outside directors, ownership structure, leverage, firm size and prior performance.

Table 19 presents the results of OLS regressions linking the fraction of independent directors to the ownership structure, leverage, firm size and prior performance. The F-values for all specifications are insignificant at the 5 % level. This indicates that prior firm performance and other independent variables are insignificant predictors of the proportion of independent directors.

⁸⁴ Indonesian Company Act, article 37.

Table 19: Cross-sectional OLS Regressions of the Proportion of Outside Directors on Board Size, Ownership Structure and Prior Firm Performance (N=190)

This table presents cross-sectional OLS regressions of the proportion of outside directors on the board size, controlling family shareholding, foreign and domestic blockholder shareholding and prior firm performance. The equation is $IDPFR_{it} = \alpha + \beta_1 BDSZ_{it} + \beta_2 FRGN_{it} + \beta_3 DOM_{it} + \beta_4 FMLY_{it} + \beta_5 LEV_{it} + \beta_6 ASST_{it} + \beta_7 ROA00_{it} + \beta_8 ROA01_{it} + \varepsilon_{it}$. The dependent variable is the representation of independent directors as of 31 December 2002 measured by categorical variable equal to 1 if the proportion of independent directors is lower than 30%, 2 if the proportion of independent directors ranges from 30% to 40% and three if the proportion of independent directors is higher than 40%. LEAD is a categorical variable equal to 1 for board chairperson being held by an independent director and 2 otherwise. BDSZ is the total number of directors. FMLY is the proportion of the immediate shareholding of controlling family to total outstanding common shares. FRGN is the proportion of foreign shareholding to total outstanding common shares. DOM is the proportion of shareholding by unrelated domestic blockholders to total outstanding common shares. ROA 2000 is the ratio of earnings before interest and taxes to book value of assets as of 31 December 2000. ROA 2001 is the ratio of earnings before interest and taxes to book value of assets as of 31 December 2001

		1	2	3	4	5	6
(Constant)	beta	0.427	0.430	0.425	0.427	0.422	0.413
	t-value	11.166	11.277	11.032	11.129	4.262	4.180
BDSZ	beta	0.002	0.002	0.002	0.002	0.002	0.002
	t-value	0.386	0.428	0.445	0.501	0.383	0.377
FRGN	beta	-0.001	-0.001	-0.001	-0.001	-0.001	-0.001
	t-value	-1.181	-1.031	-1.245	-1.121	-1.234	-1.099
DOM	beta	0.036	0.038	0.034	0.036	0.034	0.036
	t-value	1.408	1.492	1.329	1.418	1.326	1.416
FMLY	beta	-0.001	-0.001	-0.001	-0.001	-0.001	-0.001
	t-value	-1.786	-1.792	-1.820	-1.836	-1.794	-1.793
LEV	beta			-0.007	-0.008	-0.007	-0.009
	t-value			-0.534	-0.673	-0.524	-0.689
ASST						0.000	0.001
						0.033	0.157
ROA00	beta	-0.050		-0.064		-0.065	
	t-value	-0.645		-0.785		-0.783	
ROA01	beta		-0.122		-0.138		-0.140
	t-value		-1.343		-1.472		-1.476
R2		0.034	0.042	0.036	0.044	0.036	0.044
Adj_R2		0.008	0.016	0.004	0.013	0.000	0.007
F		1.315	1.601	1.139	1.406	0.971	1.202
Sig.		0.260	0.162	0.342	0.214	0.454	0.304

*** significant at 0.01 level

** significant at 0.05 level

* significant at 0.1 level

Table 20 displays the results of OLS regressions of leadership structure on the proportion of independent directors, board size, family control, blockholder, and prior performance measures. The F-values for all specifications are significant at the 1% level. The models show prior firm performance is insignificantly related to leadership structure, suggesting that an independent leadership is less likely to be a response of

poor prior performance. The proportion of independent directors is negatively related to leadership structure across specifications, suggesting that boards with a higher proportion of independent directors are more likely to have independent leadership.

Table 20: Cross-sectional OLS Regressions of Leadership Structure on the Proportion of Outside Directors, Board Size, Ownership Structure and Prior Firm Performance (N=190)

This table presents cross-sectional OLS regressions of leadership structure on the proportion of independent directors, board size, family involvement on the board, controlling family shareholding, foreign and domestic blockholder ownership and prior firm performance. The equation is $LEAD_{it} = \alpha + \beta_1 IDPFR_{it} + \beta_2 BDSZ_{it} + \beta_3 FMBD_{it} + \beta_4 FMLY_{it} + \beta_5 FRGN_{it} + \beta_6 DOM_{it} + \beta_7 ROA00_{it} + \beta_8 ROA01_{it} + \varepsilon_{it}$. The dependent variable is leadership structure defined as a categorical variable equal to 1 for board chairperson being held by an independent director, 2 otherwise. IDPFR is the proportion of independent directors to total number of directors. BDSZ is the total number of directors. FMYL is the proportion of the immediate shareholding of controlling family to total outstanding common shares. FMBD is the proportion of the family members of controlling owner serving on the board to total number of directors. FRGN is the proportion of foreign shareholding to total outstanding common shares. DOM is the proportion of shareholding by unrelated domestic blockholders to total outstanding common shares. ROA 2000 is the ratio of earnings before interest and taxes to book value of assets as of 31 December 2000. ROA 2001 is the ratio of earnings before interest and taxes to book value of assets as of 31 December 2001.

		1	2	3	4	5	6
(Constant)	beta	1.591***	1.605***	1.362***	1.371***	1.442***	1.448***
	t-value	11.027	11.027	8.961	8.898	7.778	7.783
IDPFR	beta	-0.663**	-0.682**	-0.560**	-0.572**	-0.589**	-0.601**
	t-value	-2.482	-2.549	-2.161	-2.197	-2.243	-2.279
BDSZ	beta	0.007	0.007	0.000	0.000	0.000	0.000
	t-value	0.413	0.422	-0.028	-0.020	0.008	0.019
FMBD	beta	1.012***	1.009***	0.790***	0.791***	0.772***	0.774***
	t-value	7.659	7.653	5.622	5.640	5.308	5.334
FMLY	beta			0.005***	0.005***	0.004**	0.004**
	t-value			3.773	3.725	2.196	2.191
FRGN	beta					-0.002	-0.001
	t-value					-0.814	-0.787
DOM	beta					0.026	0.032
	t-value					0.282	0.344
ROA00	beta	-0.395		-0.235		-0.191	
	t-value	-1.423		-0.866		-0.692	
ROA01	beta		-0.512		-0.296		-0.254
	t-value		-1.576		-0.928		-0.778
R2		0.298	0.299	0.348	0.348	0.351	0.351
Adj_R2		0.282	0.284	0.330	0.331	0.326	0.326
F		19.596	19.757	19.646	19.680	14.056	14.084
Sig.		0.000	0.000	0.000	0.000	0.000	0.000

*** significant at 0.01 level

** significant at 0.05 level

* significant at 0.1 level

Controlling-family ownership and controlling-family involvement on the board are positively related to the leadership structure at the 1% and 5% significance levels respectively, indicating that a family-controlled firm prefers to choose affiliated leadership regardless of prior firm performance.

The work of Börsch-Supan and Köke (2002) implies that if governance variables are endogenously determined, the OLS estimation will produce biased results. According to Seifert, Gonenc and Wright (2005), the two stages least squares (2SLS) technique will result in better estimates of the relationship between a governance variable and performance. Following this argument, Table 21 reports the results of 2SLS regressions linking the board composition and firm performance. The sample consists of 173 firms as 17 firms is absent from 2001 database. The dependent variable is ROA 2002 and the instrumental variables are the fraction of family directors, family management, family shareholdings, foreign ownership, domestic independent large shareholders and firm performance in 2001 (lag-1). The F-values for all specifications are significant at the 1% level.

Specification 1 reveals that leadership structure demonstrates a negative relationship with firm performance at the 1% significance levels, indicating that independent leadership board might drive better firm performance. Therefore Hypothesis 1a is supported. The proportion of independent directors and board size remain insignificantly related to firm performance, suggesting that the insignificant relationships are not driven by prior firm performance.

Specification 2 shows that leadership structure remains negatively related to firm performance with the inclusion of controlling family ownership into the model. However, as compared to specification 1, the significance level of such a relationship decreases, revealing that the presence of controlling family ownership affects the relationship between leadership structure and firm performance. The result, accordingly, provides empirical support for Hypothesis 2a. The proportion of independent directors

and board size remain insignificantly related to firm performance with the inclusion of such an ownership.

Table 21: Cross-sectional 2SLS Regressions of ROA on Board Composition, Controlling-family Shareholding, Controlling-family Involvement in Management and on the Board and Blockholder Ownership (N=173)

This table presents cross-sectional 2SLS regressions of ROA on board composition, family involvement on the board, family involvement in management, controlling family shareholding, blockholder ownership and control variables. The equation is $PERF_{it} = \alpha + \beta_1 LEAD_{it} + \beta_2 IDPFR_{it} + \beta_3 BDSZ_{it} + \beta_4 FMLY_{it} + \beta_5 FMGT_{it} + \beta_6 FMBD_{it} + \beta_7 FRGN_{it} + \beta_8 DOM_{it} + \varepsilon_{it}$. The dependent variable is ROA, defined as the ratio of earnings before interest and taxes to book value of assets as of 31 December 2002. LEAD is a categorical variable equal to 1 for board chairperson being held by an independent director, 2 being held by an affiliated director, and 3 being held by a family member of controlling owners. IDPFR is the proportion of independent directors to total number of directors. BDSZ is the total number of directors. FMLY is the proportion of the immediate shareholding of controlling family to total outstanding common shares. FMBD is the proportion of the family members of controlling owner serving on the board to total number of directors. FMGT is the proportion of the family members of controlling owner serving in management to total number of managers. FRGN is the proportion of foreign shareholding to total outstanding common shares. DOM is the proportion of shareholding by unrelated domestic blockholders to total outstanding common shares. The instrumental variables are FMBD, FMGT, FMLY, FRGN, DOM, and ROA as of December 2001 (lag-1).

		1	2	3	4	5	6
(Constant)	beta	0.418*	0.419	0.453*	0.433*	0.012	0.461*
	t-value	1.840	1.592	1.710	1.748	0.044	1.907
LEAD	beta	-0.084***	-0.084*	-0.102*	0.024	-0.017	-0.089***
	t-value	-2.948	-1.822	-1.770	0.105	-0.423	-2.935
IDPFR	beta	-0.222	-0.224	-0.204	-0.415	0.043	-0.578
	t-value	-0.683	-0.592	-0.570	-0.777	0.145	-1.342
BDSZ	beta	-0.022	-0.022	-0.026	-0.035	0.012	0.003
	t-value	-0.656	-0.639	-0.679	-0.773	0.357	0.080
FMLY	beta		0.000				
	t-value		0.009				
FMGT	beta			0.047			
	t-value			0.369			
FMBD	beta				-0.385		
	t-value				-0.479		
FRGN	beta					0.001**	
	t-value					2.041	
DOM	beta						-0.002
	t-value						-1.367
R2		0.085	0.085	0.074	0.075	0.139	0.086
Adj-R2		0.070	0.065	0.053	0.055	0.120	0.066
F		5.594	4.160	3.566	3.647	7.213	4.237
Sig		0.001	0.003	0.008	0.007	0.000	0.003

*** significant at 0.01 level
 ** significant at 0.05 level
 * significant at 0.1 level

In specification 3, the negative relationship between leadership structures and firm performance persists with the presence of controlling family involvement in

management. However, the inclusion of such an involvement into the model lessens the significant relationship between leadership structure and firm performance as compared to specification 1. The result suggests that controlling family involvement in management affects the relationship between leadership structure and firm performance, and accordingly, Hypothesis 3a is confirmed. Other board's properties (independent director's representation and board size) remain insignificantly related to firm performance.

Specification 4 shows that leadership structure remains negatively related to firm performance with the inclusion of controlling family involvement on the board of directors in the model. However, as compared to specification 1, the significance level of such a relationship decreases. This result suggests that the presence of controlling family involvement on the board affects the relationship between leadership structure and firm performance, and accordingly, provides empirical support for Hypothesis 3c. The proportion of independent directors and board size remain insignificantly related to firm performance with the inclusion of such an involvement.

Specification 5 shows foreign ownership is found to have significant relationship with firm performance. The significant relationship between leadership structure and firm performance disappears with the inclusion of foreign ownership in the model. These results indicate that the presence of foreign ownership affects the relationship between leadership structure and firm performance. Therefore, hypothesis 2c is supported. This implies that foreign ownership brings a strong governance mechanism through adopting board independent leadership and this strategy seems to work well as independent leadership consistently demonstrates a positive association with firm performance. Specification 6 reveals that domestic unrelated blockholder is insignificantly related to firm performance. Leadership structure remains negatively related to firm performance with the inclusion of domestic unrelated blockholder in the model. The proportion of independent directors and board size remain insignificantly related to firm performance with the inclusion of such an ownership.

Overall, the results of 2SLS regressions are consistent with those of OLS analyses. Leadership structures demonstrate a stable relationship with firm performance at the 1% (specifications 1 and 6) and 10% (specifications 2 and 3) significance levels, suggesting that leadership structures affect firm performance, and not vice versa. Put differently, the results provide evidence supportive to the claim that an independent leadership is more likely to mitigate agency problems and a particular leadership structure is less likely to be a response of specific agency problems. However, the significant relationship between leadership structure and firm performance disappears with the inclusion of foreign ownership in the model (specification 5) and decreases with the presence of controlling family ownership (specification 2), controlling family involvement in management (specification 3) and controlling family involvement on the board (specification 4). The results provide empirical support to allow this study accepting Hypotheses 1a, 2a, 2c, 3a and 3c.

The proportion of independent directors is insignificantly related to firm performance in all specifications. This finding indicates that such an insignificant relationship is robust after control for an endogeneity problem, suggesting that the proportion of outside directors is neither endogenously determined by prior poor performance, nor by the presence of other governance mechanisms. Therefore, Hypotheses 1b, 2b, 2d and 3b and 3d are refuted.

Although structured models have been widely adopted, the determinants of particular governance mechanisms lack empirical consensus and theoretical support (Fahlenbrach, 2003). This raises difficulties in identifying independent and instrument variables. Moreover, the interdependence among governance instruments implies that all of the governance variables are related to organizational outcome. Given the shortcoming of the structured model, following Lemmon and Lins (2003) and Nowland (2008), this study proposes to relate the changes in board governance measures to the changes in firm performance.

Table 22 presents the results of multivariate OLS regressions linking the changes in firm performance to changes in the governance variables. The sample consists of 173 firms as 17 firms is absent from 2001 database. The dependent variable is the changes in ROA from 2000 to 2002. The F-value for each model is significant at the 5% level except for models 3 and 5. In the absence of control variables, the adjusted R² ranges from 0.051 to 0.104.

Table 22: Cross-sectional OLS Regressions of ROA on Changes in Board Composition, Controlling-family Involvement in Management and on the Board (N=183)

This table presents the results of cross-sectional OLS regression of changes in ROA on changes in board composition, ownership structure, family involvement on the board of directors, family involvement in management, and control variables. The equation is $PERF_{it} = \alpha + \beta_1 CHLEAD0002_{it} + \beta_2 CHIDPFR0002_{it} + \beta_3 CHBDSZ0002_{it} + \beta_4 CHFMD0002_{it} + \beta_5 CHFMG0002_{it} + \beta_6 CHFMLY0002_{it} + \beta_7 CHFRGN0002_{it} + \beta_8 CHDOM0002_{it} + \varepsilon_{it}$. The dependent variable is the change in ROA during 2000 and 2002. CHLEAD0002 is the change in leadership during 2000 and 2002. CHIDPFR0002 is the change in the proportion of independent directors during 2000 and 2002. CHBDSZ0002 is the change in board size during 2000 and 2002. CHFMLY0002 is the change in the proportion of common shares held by a controlling family during 2000 and 2002. CHFRGN0002 is the change in the proportion of common shares held by foreign investors during 2000 and 2002. CHBDFLY0002 is the change in the proportion of family members of controlling owners serving on the board to total number of directors during 2000 and 2002.

		1	2	3	4	5	6
Constant	beta	0.375	0.515	0.518	0.803	0.798	0.677
	t-value	0.372	0.505	0.506	0.780	0.767	0.667
CHLEAD0002	beta	-1.045 ***	-1.147 ***	-1.140 ***	-1.058 ***	-1.059 ***	-1.312 ***
	t-value	-3.107	-3.213	-3.178	-2.944	-2.936	-3.649
CHIDPFR0002	beta	-1.616	-2.021	-1.981	-2.680	-2.671	-2.865
	t-value	-0.622	-0.764	-0.747	-1.005	-0.996	-1.085
CHBDSZ0002	beta	0.374	0.455	0.442	0.577	0.580	0.528
	t-value	0.482	0.582	0.563	0.736	0.734	0.678
CHFMD0002	beta		0.437	0.477	0.574	0.573	0.596
	t-value		0.857	0.908	1.092	1.088	1.146
CHFMG0002	beta			-0.142	-0.078	-0.078	-0.234
	t-value			-0.332	-0.183	-0.181	-0.551
CHFMLY0002	beta				-0.647 *		
	t-value				-1.773		
CHFRGN0002	beta					0.017	0.266
	t-value					0.040	0.676
CHDOM0002	beta						2.171 ***
	t-value						2.634
R2		0.051	0.055	0.056	0.072	0.072	0.104
Adj-R2		0.036	0.034	0.029	0.041	0.035	0.063
F		3.250	2.617	2.105	2.299	1.960	2.545
Sig		0.023	0.037	0.067	0.037	0.063	0.012

*** significant at 0.01 level

** significant at 0.05 level

* significant at 0.1 level

Independent directors and board size remain insignificantly related to firm performance. The leadership variable demonstrates a stable effect on firm performance at the 1% significance level (specifications 1 to 6). The negative sign suggests that firms that changed from combined to independent leadership experienced performance improvement. The result confirms that independent leadership is an effective governance mechanism in Indonesia.

8.5. Limitations of the Study

Although the present study investigates the board of directors of Indonesian listed firms, it does not control for the effect of the backgrounds of the independent directors serving on the boards under observation. This might create a bias in the results as some boards might have certain advantages over the others due to the directors' backgrounds. Literature suggests that specific backgrounds of the directors rendered the outside (or outsider) directors effective in curbing the agency problems of the management. For example, the directors with an accounting or finance background have been found as having a positive association with firm performance (Erickson et al., 2005). This finding suggests that such backgrounds provide the directors with better competence to perform their roles.

The board of directors has appeared in the literature as an internal institution that is assigned to perform advisory and control roles. Technically, these roles are reflected in the board committees as a proxy for a specific duty of the board and "...represent a mechanism for companies to organise their boards" in promoting the overall effectiveness of the boards (Cotter & Silvester, 2003, p.211). Accordingly, a more rigorous approach to investigating the association between independent directors and firm performance would be to focus on the presence of such directors in the monitoring committee (Klein, 1998; 2002). By relating a particular committee with a specific outcome, it is believed would deliver a clearer test of the association between the effectiveness of independent directors' monitoring and organizational outcomes. However, this study does not separate the representation of independent directors on the

board into a more specific category based on whether such directors are assigned to the monitoring or to other committees. This issue is important in identifying the differential impact of independent directors in specifically performing their monitoring role.

Rosenstein and Wyatt (1990) have stressed the importance of disentangling between an outsider director who is nominated by management and one which is nominated and appointed by major shareholders. This view is derived from the premise claiming that the nomination of outside directors by management provides them with conditions to control the board and that these nominations invite skepticism about the effectiveness of independent directors in performing their role as a “good referee” (Vance, 1983). This view implies that the nominating parties have an important impact on the outside director’s ability to make independent judgments on firm performance. However, this study treats the independent directors equally, irrespective to their nomination and appointment process. This procedure might create bias in the result, since the independent directors nominated by management or controlling owners could have a different effect as compared with the independent directors who are nominated by minority shareholders.

Another shortcoming is in regard to the variable measurement of controlling-family ownership. This study measures such a variable by aggregating their immediate shareholdings via their intermediate companies. This procedure leads to the absence of separation between voting rights and cash flow rights, and accordingly this study does not further disentangle between the entrenchment effect and the alignment incentive effect. Although there is significant incidence of governance research aggregating such effects,⁸⁵ it might have different impacts on the relationship between internal governance mechanisms and firm performance. Zhang (2003) argues that the expropriation is more pervasive in firms with a divergence between voting rights and cash flow rights, and firms that are a part of business groups. Accordingly, relying on their immediate shareholding might understate the incentive of controlling owners in committing

⁸⁵ See for example Guriev et al., (2003), Welch (2003) and Klasa (2002).

expropriation as Indonesian listed firms exhibit a higher wedge between cash flow and voting rights (Claessens et al., 2002).

This study uses accounting numbers to define the performance indicator as they have been independently verified by external auditors. According to Chung, Firth and Kim (2005), accounting-based indicators might suffer from earnings management that distort financial statements and therefore could be considered as opportunistic behavior by management. Although it is not necessarily illegal, earning restatement might benefit one contracting party at the expense of others. Fan and Wong (2002) and Bhattacharya, Daouk, and Welkerp (2002) believe that Indonesian listed firms inflate their earning statement generously which is partly attributable to the ownership structure. This finding implies that a study investigating the relationship between governance mechanisms and accounting performance in Indonesia should control for the likelihood of the presence of earnings management. However, this study leaves this issue unattended which might lead to the failure to capture the true firm performance as a consequence of the presence of higher earnings restatement. Eventually, the absence of a proper procedure to control for this problem might create a bias in investigating the association between governance mechanisms and firm performance.

Another issue of concern may come from the procedure that treats identically the level of investor protection provided by the country of origin of a foreign investor. The importance of foreign investors in governance mechanisms hinges upon the presumption that their countries of origin, particularly those with developed economies like the US, provide investors with a strong protection through various regulations and market mechanisms (Mitton, 2004). The greater scrutiny and monitoring by the market will eventually force the firms to ensure that they monitor their foreign investments (Boardman, Shapiro & Vining, 1997). According to Leuz, Lins and Warnock (2005), the level of investor protection differs across countries implying that the pressure of effective monitoring will vary across foreign investors. However, this study did not differentiate between foreign investors based on their country of origin which might lead

to the failure to reflecting the true performance effect of the differences of monitoring activities by such investors.

Although this study have accounted for the effect of firm size and leverage, literature suggests that other firm specific variables, such as region, number of employee, and industry might have an impact on the association between the board of directors and organizational outcome. The importance of region hinges upon the presumption that local regulation system potentially affects the effectiveness of internal governance mechanisms (Heron & Lewellen, 1998). The number of employee has been claimed as being related to the complexity of decision making and communication and coordination problems that reduce the ability of any given individual to initiate change, to affect the direction of the firm, and to influence the organizational outcome (Daily & Dalton, 1993; Yermack, 1996). This implies the number of employee is more likely to affect the relationship between the board composition and organizational outcome. The type of industry has been claimed as having a systematic performance variation indicating that industry characteristics may confound the association between board composition and firm performance in a cross-sectional analysis (Barnhart, Marr & Rosenstein, 1994). However, this study leaves such firm-specific variables leaves uncontrolled that reduce the generalisation of the results. Accordingly, further research that incorporates such variables would be worth of governance literature.

8.6. Conclusion

This chapter presents empirical testing of hypotheses using univariate and multivariate approaches. As summarized in Table 23, it has been documented that leadership structure is positively related to firm performance, while the proportion of independent directors and board size demonstrate an insignificant relationship to firm performance. Ownership structure and the family members of controlling owners serving in management and on the boards are more likely to negate the link between independent leadership and firm performance. The next chapter discusses the empirical finding in detail.

Table 23: Summary of Hypothesis Testing

Number	Hypothesis	Result
H _{1a} :	The board's independent leadership is positively related to firm performance.	Confirmed
H _{1b} :	The proportion of independent directors is positively related to firm performance.	Rejected
H _{2a} :	The presence of ownership concentration will moderate the association between the board's independent leadership and firm performance.	Confirmed
H _{2b} :	The presence of ownership concentration will moderate the association between the fraction of independent directors and firm performance.	Rejected
H _{2c} :	The presence of external large shareholders will moderate the association between the board's independent leadership and firm performance.	Confirmed
H _{2d} :	The presence of external large shareholders will moderate the association between the fraction of independent directors and firm performance.	Rejected
H _{3a} :	The presence of family members of controlling owners serving in management will moderate the association between the board's independent leadership and firm performance.	Confirmed
H _{3b} :	The presence of family members of controlling owners serving in management will moderate the association between the fraction of independent directors and firm performance.	Rejected
H _{3c} :	The presence of family members of controlling owners serving on the board will moderate the association between the board's independent leadership and firm performance.	Confirmed
H _{3d} :	The presence of family members of controlling owners serving on the board will moderate the association between the fraction of independent directors and firm performance.	Rejected

Chapter 9: Conclusion, Discussion, and Implications

9.1. Introduction

In the previous chapters, the descriptive statistics and hypotheses testing were presented. Five of the ten hypotheses are confirmed while the remaining five hypotheses are rejected. It is documented that firm performance is potentially affected by independent leadership while the proportion of independent directors is found to have an insignificant relationship with firm performance. This chapter presents a discussion of empirical testing and the policy implications. This chapter begins with a summary of empirical findings followed by discussions of the findings. The last section provides the policy implications.

9.2. Summary of Empirical Findings

The first proposition states that the separation of ownership and control creates the divergence of interests of the principals and the agents (Jensen and Meckling, 1976). Such divergence might be mitigated by internal governance mechanisms responsible for control decisions whenever such mechanisms are independent of management (Jensen, 1993; Fama, 1983). The independent property will enable this mechanism conducting objective assessments of management performance (Jensen, 1993). Eventually, an objective assessment might increase the sensitivity of management performance to the disciplinary action provided by the market for corporate control and thereby promote the assurance that the interests of shareholders, rather than those of management, are represented (Fama, 1980). Accordingly, an independent internal control mechanism is more likely to better align the interests of the agent with those of the principal. As control reduces the opportunistic behaviour of the agent, all else being equal, the resultant lower potential agency cost will lead to better firm performance.

Univariate analysis reveals that leadership structure is correlated with firm performance at a conservative level (Section 8.3). Multivariate data analysis shows that independent leadership is positively related to firm performance. The relationship is stable in the presence of ownership structure, control-enhancing mechanisms and control variables.

Instrumental variable analyses produce a consistent result, suggesting that leadership structures are more likely to affect firm performance and not vice versa. Accordingly, the result allows the study to accept Hypothesis 1a.

Descriptive statistics (Section 7.3.2) suggests that most Indonesian listed firms have insider dominated boards and have complied with the regulation requiring the firms to appoint at least 30% independent directors serving on the boards. Univariate analysis reveals that the fraction of independent directors is insignificantly associated with firm performance (Section 8.3). Multivariate data analysis shows that the proportion of independent directors is insignificantly related to firm performance. The result is robust after controlling for the measurement of variables of interest, linearity, and endogeneity issues and therefore Hypothesis 1b is rejected. The result implies that the empirical tests for Hypotheses 2b, 2d and 3b become irrelevant.

Proposition 2 states that corporate governance consists of several devices or mechanisms that could be broadly categorised as being either internal or external (Denis & McConnell, 2003). Such mechanisms might construct various configurations, which may possibly produce similar outcomes, indicating that governance mechanisms might complement and substitute for each other (Danielson & Karpoff, 1998). The substitution argument implies that the board monitoring would be assume considerable importance in the absence of other governance mechanisms, while the complementary argument suggests that the board monitoring role would be effective whenever other strong governance mechanisms exist (Agrawal & Knoeber, 1996). Accordingly, all else being equal, the relationship between board composition and firm performance is affected by the presence of alternative governance mechanisms.

Although the creditors might serve as the alternative governance mechanisms of the board in monitoring management, the lending banks in Indonesia typically belong to the business group, which is owned by the same controlling family (Patrick, 2001). This group-affiliated financing pattern leaves the bank with less independence to monitor management and consequently, the available alternative monitoring mechanism is the

presence of the large shareholders. Descriptive statistics reveals that the average immediate ownership by the largest shareholders is 55 %, indicating the prevalence of ownership concentration of Indonesian listed firms. Ownership by controlling shareholders is negatively correlated with firm performance, suggesting that better firm performance is more likely to be observed with diffused ownership. OLS regression analysis shows that ownership by a controlling family is consistently negatively related to firm performance. Although 2SLS analysis produces an inconsistent result, the positive relationship between independent leadership and firm performance decreases in the presence of controlling owners. This result is robust after controlling for measurement, non-linearity and endogeneity issues, and therefore Hypothesis 2a is confirmed.

The absence of unrelated large shareholders is the salient feature of Indonesian listed firms. Unrelated foreign and domestic shareholders are found in 29% and 12% of the dataset respectively. Unrelated domestic large shareholders exhibit an insignificant relationship with firm performance while OLS regression analysis reveals that foreign shareholding is an inconsistent predictor of firm performance. However, 2SLS analysis shows a positive relationship between foreign ownership and firm performance. This indicates that foreign ownership is more likely to enhance firm performance. In the presence of foreign ownership, the significance of the relationship between board leadership and firm performance decreases. This finding indicates that foreign ownership moderates such association and therefore allows the study to accept Hypothesis 2c.

Proposition 3 posits that the optimal control system might be achieved whenever there is a balance of power between the agent and the principals (Jensen, 2000). If the power is concentrated in the agent, it might prevent the manager market for corporate control to discipline management (Fama, 1980). The absence of the threat of dismissal as a necessary condition for corporate control discourages managers from pursuing such action that would maximize the interests of principals. Under this circumstance, the manager might prefer to choose the optimal self-interest behaviour that is detrimental to

firm performance and outside shareholders' wealth (Fama, 1980). Given that the higher power insulates the agent from disciplinary action, all else being equal, the effectiveness of the board in improving firm performance through their monitoring role would be reduced.

Section 7.3.2 reveals that controlling owners appoint their family members to serve in management and on the boards in 71% and 75% of Indonesian listed firms respectively. Given their higher shareholding, such appointments provide the management and directors of the controlling family with the power to outvote the opposing proposals. The univariate analysis shows that such involvements are negatively correlated with firm performance. Multivariate data analysis reveals that the effect of board leadership on firm performance decreases in the presence of family involvement in management and therefore Hypothesis 3a is confirmed. The relationship between board leadership and firm performance disappears when the model includes the family involvement on the board. Therefore Hypothesis 3c is accepted.

Proposition 4 states that ownership structure determines the distribution of power and control associated with the shareholding that leads to the specific nature of agency conflict (Shleifer and Vishny, 1997). Ownership concentration delivers the control of the firm to the majority shareholders who have the incentive and power to deprive minority shareholders of their rights (Shleifer and Vishny, 1997). Eventually, an ownership concentration will create an uncontested control, which facilitates majority owners to commit expropriation (Shleifer and Vishny, 1997). Under this circumstance, majority owners will prefer to maintain the private benefit of control that is consistent with their interests (Dyck and Zingales, 2004). Accordingly, such owners are more likely to oppose the governance reform that might threaten their private benefit of control. All else being equal, the majority shareholder will seek to prevent distribution of control to the minority shareholders.

Board composition has been quoted as having an important impact on corporate control (Jensen, 1983). Agency theory claims that outsider directors have the incentive to

develop a reputation as a “good referee” and therefore will better monitor management (Fama, 1980). In the case of Indonesia, the requirement of appointing independent directors to serve on the board and the presence of an independent board chairperson might deliver a particular level of corporate control to the minority shareholders. Therefore it is expected that majority shareholders will oppose the requirement and prefer to adopt affiliated leadership. Empirically, the study predicts that the proportion of independent directors and independent leadership is negatively related to the level of ownership by majority shareholders.

Descriptive statistics reveal that Indonesian listed firms are typified by ownership concentration in the hand of controlling families. Most of the firms exhibit insider-dominated board and affiliated board chairpersons. Correlation analysis reveals that the proportion of independent directors is insignificantly associated with family ownership. Independent leadership is negatively associated with family ownership. Foreign ownership is found to have a significant association with the independent leadership, while domestic large shareholders are positively related to the fraction of independent directors. Board independent leadership is negatively related to controlling-family ownership and family involvement on the board. This allows the study to accept Hypothesis 5a. Multivariate data analysis shows that family ownership is an insignificant predictor of the proportion of independent directors, and therefore Hypothesis 5b is rejected.

9.3. Discussion

9.3.1. Board Composition

The study finds that independent leadership is positively related to firm performance. The finding is consistent with those of Coles et al., (2001) of large US corporations, Pi and Timme (1993) of US commercial bank holding companies, and Faccio and Lasfer (2000) of a large dataset of London Stock Exchange firms. As argued by Fama and Jensen (1983), separated leadership enhances the separation of management decisions from control decisions that promotes board independence. Accordingly, independent leadership provides the board with a better position to monitor management.

The importance of board leadership hinges on the view claiming that the chairperson possesses the authority to organize board activity and hence has the greatest influence over the board (Jensen, 1993). The influence of the board chairperson could be greater in the Indonesian setting due to the specific culture. According to Hofstede (1980), Indonesia is characterized by higher power distance that grants the leader a considerable privilege. This view is consistent with the work of Adnan, Chatterjee & Nankervis (2003) claiming that Indonesian collectivism culture emphasizes the role of the entity's leader. The members of the entity are expected to demonstrate a loyalty by supporting the leader's decisions without questioning them. As the board chairperson possesses greater influence in Indonesia, consequently the effectiveness of the board monitoring role would be enhanced more with a separated leadership.

This study finds that the fraction of independent directors falls mostly in the range of 30% to 40%. Further analysis reveals that the fraction of independent directors is insignificantly determined by prior firm performance and other governance mechanisms. This suggests that the level of outsider directors' representation is exogenously determined by the level of the agency problem. Given that the average board size consists of three directors, the finding indicates that firms tend to appoint a particular fraction of independent directors in order to meet the minimum requirement.

The global convergence toward a more prominent role for independent directors is based on the presumption that the boards with more independent directors will lead to better decisions (Dahya & McConnel, 2005). This presumption is derived from the premise that a monitoring role is more likely to be better performed by independent directors. However, this study found that the proportion of independent directors is insignificantly related to firm performance. According to Palepu, Khanna and Kogan (2002), there exists a gap between *de jure* and *de facto* convergence⁸⁶. That work suggests that *de jure* convergence does not necessarily lead to actual convergence in practice. This implies

⁸⁶ Gilson (2001) suggests that one should differentiate between convergence in form and in function. The former is similar to *de jure* while the latter refers to the *de facto* convergence.

that the adoption of *de jure* principles in board reform in Indonesia potentially does not adopt the *de facto* spirit of the principles.

Complementary to the convergence issue, a study by the World Bank (2005) finds a lack of institutional reform that might prevent the firm from appointing 'truly' independent directors. Specifically, that work finds an absence of nominating committees that would enable management, which represent the interest of the controlling family, to nominate the directors. Further, the same study also reports that the common voting method of directors' appointments follows the slate system. The inappropriate nomination and voting systems leave minority shareholders with "...no alternative other than to approve the whole package" proposed by majority shareholders (World Bank, 2005, p.7). This will provide majority shareholders with the condition to control the board and facilitate them in nominating individuals who are less likely to challenge their private benefit of control, to serve as an independent director. Accordingly, such procedures enable the controlling owners to establish the board in favour of their interests which potentially reduces the directors' independence in scrutinizing management action.

Mak and Li (2001) raise an issue of cultural framework in analysing the pattern of corporate governance in Asian countries. It is argued that the way of doing business by Asian firms is different from that of their Western countries counterparts. According to Hofstede (1980), Indonesia is characterised by a collectivism culture, where the harmony and solidarity are the most important values in the society. Within this culture, individuals are expected to promote personal relationships by avoiding a confrontation. This culture implies that the independent directors will face difficulties in creating a dissenting opinion from the other board members affiliated to the controlling family. Consequently, the actual control of the firm still rests in the hands of management, which represents the interests of controlling owners. Under these circumstances, the independent director is less likely to be able to deliver any performance improvement.

9.3.2. Ownership Structure

The study finds that most Indonesian listed firms have majority owners with 20% shareholding or higher, suggesting that ownership is concentrated in the hands of majority shareholders. According to Gul and Tsui (2004), a dispersed ownership is an exception in Asian economies, although the level of ownership concentration varies across firms and countries. Literature suggests that large shareholdings might serve as a governance mechanism that benefits the firm. Higher shareholding by insiders has been quoted as enhancing the convergence of interests of principals and agents (Jensen & Meckling, 1976) while higher ownership by outside shareholders will provide the holders with the incentive to better monitor management (Shleifer & Vishny, 1986). Eventually, the continuous scrutiny by large shareholders will encourage firm performance and this benefit of large shareholders will be enjoyed by other corporate shareholders. Therefore, the shared-benefit of control associated with the presence of large shareholders might benefit the firms and minority shareholders.

However, the study reveals that ownership concentration by family is negatively related to firm performance. Consistent with the finding, previous studies have documented that ownership concentration negatively affects firm performance whenever such concentration is held by family (Gadhoun, 2000; Ehrhardt & Nowak, 2003). Morck and Yeung (2003) suggest that control by family serves as a device in pursuing the family interest that is not shared with the other shareholders. The private benefit of control associated with ownership concentration facilitates the family to divert firm resources in order to maximize their wealth and thereby deprive minority shareholders of their rights. Accordingly, the finding supports the view that ownership concentration by family is more likely to be related to the expropriation hypothesis that is detrimental to firm performance.

This study shows that the positive relationship between independent leadership and firm performance is moderated by the presence of foreign shareholding. Foreign investors commonly form a joint venture with local business groups in Indonesia that provides them with access and connections to the political elite and government officials (ADB,

2000). According to Boardman, Shapiro and Vining (1997), foreign investors face performance pressure and continuous scrutiny from their country of origin. This provides foreign investors with the incentive to adopt better corporate governance. In relation to the board independence, the study finds that foreign investors are associated with independent leadership. This indicates that foreign investors prefer to adopt independent leadership in order to enhance the effectiveness of board monitoring than to appoint greater numbers of outsider directors. This strategy appears to work well as the study finds that independent leadership firms demonstrate superior firm performance.

9.3.3. Controlling-Family Involvement in Management and on the Board

The study finds that the members of controlling families serving in management, on the board and in both are found in 68%, 71% and 63% of Indonesian listed firms respectively. These figures suggest that the involvement of controlling families in management and on the board is the salient feature of Indonesian listed firms. Consistent with the findings, some studies have documented the prevalence of such involvements in management (Khanthavit, Polsiri & Wiwattanakantang, 2002; Brunello, Graziano & Parigi, 2003; Nam, 2004) and on the boards (Tabalujan, 2002; Yeh & Woidtke, 2005). According to Nam (2003, p.2), in most Asian countries "...controlling owners are typically preoccupied with conducting the managerial function themselves".

Urtiaga and Tribo (2004) suggest that family members share the same interests amongst themselves, and they act collectively. This framework implies that the interest of controlling-family members serving on the board is assumed to be necessarily similar to those of management that has been claimed as representing solely the interest of the controlling family (Morck & Yeung, 2003). Therefore, such involvements could be seen as combining management decisions and control decisions in the hands of family. According to Fama and Jensen (1983), a proper check and balance system requires that such decisions, almost by definition, be separated. Consequently, the findings provide the undeniable fact that a proper check and balance system is absent in most Indonesian listed firms.

Investor protection provided by the legal system in Indonesia is relatively weak. La Porta et al. (1998) argue that contracts enforcement relies on the shareholders whenever such enforcement by the State is weak. Given the family members serving in management and on the board share the same interests, such involvements might promote the convergence of interests of agents and principals and consequently reduce the likelihood of opportunistic behaviour. Under this view, such involvements could be seen as a strategy to mitigate contract enforcement problems. This will lead to the lower monitoring cost and consequently to better firm performance. Accordingly, such involvement might benefit the firm and minority shareholders (Nam, 2002).

Aside from the legal perspective, the prevalence of family involvement in management and on the boards could be analysed within a cultural framework. Adnan, Chatterjee and Nankervis (2003) suggest that Indonesian culture is constructed from Chinese, Indian, Islam, and Dutch cultures. They note that Indonesia is inhabited by various tribes and characterized by the existence of its multilingual nature that "...has created a unique amalgam in Asian context" and might lead to the "...complexity in understanding some of the latent belief systems that guide Indonesian work culture and institutional frameworks" (p.199)⁸⁷. In addition, Berglöf and Claessens (2004) posit that enforcement is typically weaker with the existence of social and cultural heterogeneity.

The Asian culture emphasizes collectivism and harmony values that are designed to achieve the interest of a particular group (Nam, 2001). Within this culture, a family heads is responsible for fulfilling family obligation by them providing job opportunities to their family members⁸⁸ (Nam, 2001). Accordingly, appointing family members to serve in management and on the board could be seen as a device by controlling owners

⁸⁷ For example, Indonesians would simply show a certain "body language" in order to deliver a disagreement opinion. Native Indonesians commonly understand such indirect communications, as the direct communication might "...cause loss of face" (Adnan and Nankervis, 2003, p.208). According to Morrison and Conaway (2007), Indonesians rarely say "no" as they believe that it is impolite to openly disagree with someone. Further, they suggest that "...the listener is expected to be perceptive enough to discern a polite "yes (but I really mean no)" from an actual "yes." (p. 36-37).

⁸⁸ This view is consistent with expropriation hypothesis advanced by La Porta et al. (2000), who suggest that expropriation takes the form of diversion of corporate opportunities from the firm and appointing possibly unqualified family members to managerial positions.

to fulfil their family responsibility and at the same time facilitate them to rely on the interpersonal relationship between family members rather than formal contracts⁸⁹. However, the study finds that such involvements are negatively related to firm performance. This indicates that the findings are consistent with an entrenchment hypothesis associated with family involvement in management and control decisions (Brunello, Graziano & Parigi, 2003; Yeh & Woidtke, 2005; Yeh, 2005). The work of Morck and Yeung (2003) suggests that higher insider ownership by management and directors, who are family members of controlling owners, provides them with sufficient voting power to secure their control of the firms. The entrenchment effect of such involvements facilitates the controlling family to divert firm resources that leads to the higher residual loss.

The analysis reveals that the involvement of a controlling family on the board is found to negate the link between independent leadership and firm performance. This finding suggests that a substantial fraction of family members serving on the board provides controlling owners with majority opinion that facilitates their control of board's decisions. Under this circumstance, the independent director who serves as board chairperson would be outvoted by majority opinion. Consequently, the finding implies that independent leadership potentially benefits the firm whenever the board comprises sufficient non-affiliated directors.

The study finds that controlling-family shareholdings and their involvement in management and on the board exhibit different impacts on the relationship between independent leadership and firm performance. In the presence of controlling-family shareholdings and involvement in management, the significance of the relationship between independent leadership and firm performance decreases. Such a relationship disappears when the involvement on the board is taken into account. *The different impact indicates that the involvement on the board creates a higher entrenchment problem than the involvement in management does.* This finding suggests that the presence of a controlling family does not necessarily negate the link between

⁸⁹ See Backman (2004) for further discussion.

governance mechanisms and firm performance unless they dominate the board of directors. Nevertheless, this finding underlines the importance of disentangling the impact of family ownership, family involvement in management and family involvement on the board on firm performance.

The different effects of such involvements might help to explain why controlling owners appoint their family members to serve in management teams and on the board of directors simultaneously. *Involvement in the management could be seen as a device by controlling owners in ensuring that management decisions are consistent with the private interests of the owners. On the other hand, involvement on the board of directors enables the controlling owners to prevent effective monitoring from internal governance mechanisms.* The higher family involvement on the board and in management permits controlling owners to deprive minority investors of their rights and, at the same time, lessens the board's ability to perform a monitoring role. Consequently, higher family involvement in management teams and on the board is more likely to lead to worse agency problems that discourage firm performance.

9.4. Policy Implications

Indonesian listed firms are characterized by higher ownership concentrations by a controlling family. Such concentrations provide majority shareholders with sufficient voting powers to control a firm's operation. This excessive control of the firm facilitates majority shareholders to pursue their own interests, which diverges from maximizing firm performance. This feature indicates that the most important factor of corporate governance in Indonesia is the existence of powerful majority shareholders that have an almost entire control of the firm. According to Jensen (2000), an optimal control system might be achieved whenever there is a balance of power between the contracting parties. This argument implies that governance reforms in Indonesia should address the excessive control by majority shareholders that has been proven as harming firm performance.

The discussion reveals that board composition, ownership structure, and control-enhancing mechanisms are interrelated. Control by majority owners is further exacerbated by the appointment of their family members to serve in the management and on the boards which enables them to influence management and control decisions simultaneously. Although it might reduce monitoring costs, the study finds that such involvements are negatively related to firm performance which is consistent with the expropriation hypothesis. Agency literature suggests that such opportunistic behaviour might be mitigated by proper checks and balances systems that separate management decisions and control decisions (Denis, 2001; Denis & McConnell, 2003; Gillan, 2006). Consequently, the finding suggests that appropriate corporate governance that seeks to separate the management decisions from control decisions should be encouraged.

The JSX has endorsed the regulation requiring that listed firms appoint independent directors to serve on the Board of Directors. The requirement is intended to enhance the board independence which is consistent with promoting the separation between management decisions and control decisions. However, the study finds that the representation of independent directors is insignificantly related to firm performance. It is argued that the insignificant relationship might be attributed to the lack of independence of outsider directors due to the particular voting and nomination procedure. The existing common procedures enable majority owners to control the nomination and facilitate the appointment independent directors who would not threaten their private benefit of control. Accordingly, a voting system that properly accommodates the interest of non-controlling owners, such as cumulative voting, and establishing a nomination committee, is needed in order to reduce the majority control of the independent director's appointment.

The study finds that controlling owners commonly appoint a family member to serve as a board chairperson, which facilitates majority shareholders to control the board activities in order to ensure that their interests are well respected. Given that the board is assigned primarily as monitoring device, such appointment will discourage the separation between control and management decisions. Therefore, although Indonesia

adopts a two-tier board system, this study argues that a combined leadership might exist in Indonesia with the appointment of a controlling-family member serving as board chairperson. The study finds that independent leadership is found to have a positive relationship to firm performance, suggesting that controlling-family member serving as a board chairperson is detrimental to firm performance. This indicates that controlling owners actually defeat the check and balance system whenever the board chairperson position one of is held by their family member. Based on this finding, corporate governance reform in Indonesia should address the issue

Foreign investors are found to have a positive relationship with firm performance. Foreign shareholding also demonstrates significant association with independent board leadership. Further analysis reveals that foreign investors adopt independent leadership as a governance mechanism and this strategy appears to work well as the study finds that independent leadership is positively related to firm performance. This finding offers supportive evidence that a foreign investor is more likely to improve corporate governance so that it enhances firm performance. Accordingly, the finding suggests that Indonesia would benefit whenever the country is able to attract foreign investments.

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Appendix 1

Table 24: Empirical Studies Investigating the Association between the Proportions of Insider/Outsider Directors and Firm Performance

Authors	Period of data	Sample	Composition measurement	Measure of Firm Performance	Control for internal governance mechanisms	Results
Barnhart et al. (1994)	1990	369 of Standard and Poor's 500	Outsider	Market to book value	Blockholder and managerial ownership	<ol style="list-style-type: none"> 1. The proportion of outsider directors is positively related to the firm performance (OLS). 2. The proportion of outsider directors has curvilinear relationship with performance in the instrumental variable analysis.
Baysinger and Butler (1985)	1970-1980	266 US major firms from Forbes	Outsider	ROE industry-adjusted	None	<ol style="list-style-type: none"> 1. Firm with higher proportion of independent directors at the beginning and ending period have the best performance in the ending period. 2. Firm with lower proportion of independent directors at the beginning and ending period have the lowest performance in the ending period.
Baysinger et al. (1991)	1981-1983	176 Fortune 500 firms	Insider	Average R&D spending per employee	Blockholder	<ol style="list-style-type: none"> 1. The proportion of inside directors positively affects the R&D spending.
Berry (2006)	1979-1997	823 firm-years that went public 1979-1986	Outsider	Survive, acquired, and bankrupt eleven years after IPO	Firm size, performance, risk (volatility), and asset composition	<ol style="list-style-type: none"> 1. The proportion of independent directors in survive and acquired firms increases, but not for bankrupt firms
Bhagat and Black (2002)	1985-1995	928 US large firms	Insider, Grey, Independent	Q, ROA, ROS, Market adjusted return	Board size, CEO ownership, outsider directors ownership, firm size	<ol style="list-style-type: none"> 1. Board independence has negative association with all three performance measures. 2. Past performance has negative association with board independence suggesting that poor performance adopt more independent directors on the board.

Block (1999)	1990-1994	1026 of firms announcing additional one outsider directors only	Outsider	Cumulative abnormal return	None	<ol style="list-style-type: none"> 1. The impact of the new appointment of outsider director is positive with the greatest effect on the 30-50 percent range of outsider fraction before announcement. 2. The pattern shows non-monotonic relationship
Dahya and McConnell (2005)	1989-1999	700 industrial and financial firms of the LSE	Outsider and insider	Industry and size-adjusted stock returns	None	<ol style="list-style-type: none"> 1. Stock price reaction to outsider directors appointments is positive and significantly greater than the reaction to inside CEO appointments
Daily and Dalton (1992)	1990	100 small firms	Outsider	ROA, ROE, P/E ratio	None	<ol style="list-style-type: none"> 1. The proportion of outsider directors is marginally associated with higher firm performance
Daily and Dalton (1993)	1990	186 listed small firms	Outsider directors	ROE, ROA, Return	None	<ol style="list-style-type: none"> 1. The proportion of outsider directors is positively related to the performance measures
Daily and Dalton (1994)	1972-1982	Pair of 57 bankrupt and survivor firms	Insider	Bankruptcy	None	<ol style="list-style-type: none"> 1. Bankrupt firm have a greater proportion of affiliated director than survivor firm
Dehaene, De Vuyst and Ooghe (2001)	1995	61 listed and 61 non listed Belgium firms	Outsider	ROA, ROE	Leadership structure and board size	<ol style="list-style-type: none"> 1. The proportion of outsider directors has positive relationship with ROE with low r square. 2. The larger outsiders and relative importance of outsiders is stronger in listed companies.
Del Guercio, Dann and Partch (2003)	1996	476 closed-end funds offered by 105 investment complexes	Outsider	Fund expense ratio, Discount levels	Board size	<ol style="list-style-type: none"> 1. The proportion of outsider directors is negatively related to fund-expense ratio 2. The proportion of outsider directors is insignificantly related to discount level

Erickson et al. (2005)	1993-1997	679 observations (unbalanced) and 330 (balanced) panel of Canadian firms	Outsider	Tobin Q – industry adjusted	Board size and ownership structure	<ol style="list-style-type: none"> 1. The proportion of outsider directors has negative effect on Tobin Q 2. The proportion of outsider directors from financial institution have positive effect on Q
Faccio and Lasfer, (2000)	1996-1997	1650 firms of London Stock Exchange firms	Outsider	Q ratio, ROA, ROE	Blockholders Managerial ownership	<ol style="list-style-type: none"> 1. Firm with at least 3 outsider directors displays highest performance at low level of managerial ownership and displays lowest performance at higher level of managerial ownership.
Fosberg (1989)	1979-1983	127 pairs of firms (90 pairing majority vs. non majority outsider directors firms 37 pairing majority vs. super majority outsider directors)	Outsider	ROE, Sales, General & Administrative expense, Number of employee, Sales to assets, SGA to assets, EMP to assets	None	<ol style="list-style-type: none"> 1. All of performance indicators displays insignificant differences between majority and non-majority 2. All of performance indicators displays insignificant differences between majority and super-majority
Haniffa and Hudaib (2006)	1996-2000	347 firms listed in Kuala Lumpur Stock Exchange	Outsider	Q ratio, ROA	Board size, leadership structure, ownership structure	<ol style="list-style-type: none"> 1. The proportion of outsider directors is insignificantly related to Q ratio and ROA
Hermalin and Weisbach (1991)	1971	142 firms of NYSE	Outsider	Tobin Q	Ownership structure	<ol style="list-style-type: none"> 1. Overall board composition is insignificantly related to Tobin Q 2. Outsider directors with longer tenure is positively related to Tobin Q
Hossain et al. (2001)	1991-1995	633 firm-years of New Zealand	Outsider	Tobin Q	Ownership concentration	<ol style="list-style-type: none"> 1. The proportion of outsider directors is positively related to the firm performance 2. The interaction between outsider directors and legislation is insignificant suggesting that Company Act 1993 do not affect such association

Hutchinson and Gul (2004)	1998-1999	310 top listed Australian firms	Insider	ROE	Insider ownership	1. The interaction between Investment Opportunity Set and non-executive directors is positively related to ROE suggesting that negative association between IOS and performance is weaker with higher proportion of outsider directors.
Judge Jr. (1994)	1985 – 1987	162 general medical hospitals	Outsider	Financial performance, Social performance	None	1. The proportion of outsider directors is negatively related to financial performance 2. The proportion of outsider directors is positively related to social performance
Kesner (1987)	1983	250 firms of fortune 500	Insider	ROA, ROE, PM, EPS, Market return	None	1. The proportion of insider directors has positive association with ROA and PM
Krivogorsky (2006)	2000-2001	81 firm of EU listed in US	Outsider Insider	ROA, ROE, MTB	Blockholder Managerial ownership	1. The proportion of outsider directors has positive relation with firm performance 2. Insider directors is insignificantly related to firm performance
Lawrence and Stapledon (1999)	1995	100 top listed Australian firms	Outsider	Market return	None	1. The proportion of outsider directors is negatively related to the market return. 2. The proportion of outsider directors is insignificantly related to accounting performance
Matolcsy et al. (2004)	2001	306 Australian listed firms	Outsider	Market value of equity per share	None	1. The interaction between the proportion of outsider directors and growth is positively related to firm performance indicating that outsider directors are beneficial at the presence of growth options
Peng, Buck and Filatotchev (2003)	1995-1996	314 large Russian firms from six major industrial region		Perceived ROI within 7 Liker scale	Firm size	1. No significant positive association between the proportion of outsider directors and firm performance

Postma et al. (1999)	1996	94 firms of Dutch non-financial firm listed in Amsterdam Exchange	Outsider	Return, Composite average of ROA, ROE, ROS	None	1. Board attribute have no significant impact on firm performance
Rosenstein and Wyatt (1990)	1981-1985	1251 announcements (622 non-contaminated, 629 contaminated)	Outsider	Market return (cumulative standardized prediction error)	None	1. The announcements of outsider directors' appointment produce positive return for total and non-contaminated sample is significantly positive. However, abnormal returns are small in absolute magnitude
Rosenstein and Wyatt (1997)	1981-1985	170 inside directors appointment announcement of NYSE firms	Insider	Market return	Leadership structure and insider ownership	1. The announcements of insider director's appointment produce positive return for intersection of inside ownership 5% to 25% and outsider directors 60%.

Appendix 2

Table 25: Empirical Studies Investigating the Association between Leadership Structure and Firm Performance

Authors	Period of data	Sample	Measure of firm performance	Control for governance mechanism	Results
Baliga et al. (1996)	1980-1991	61 firms changes from separate-to-combined 37 firms changes from combined-to-separate 12 firms remain separated and 111 firms remain combined	Cumulative Abnormal Return, ROA, ROE, Operating cash flow to total assets ratio, Operating cash flow to sales ratio	None	<ol style="list-style-type: none"> 1. Leadership structure is insignificantly related to firm performance as the performances insignificantly differs between groups 2. The authors mention the possibility that such result might be driven by other governance mechanism adopted by the firms
Brickley, Coles and Jarrell (1997)	1984–1991	1628 US firms	Return on Capital 1988, Stock return 1988, Industry-adjusted return on capital 1988, Industry-adjusted stock return 1988, Return on Capital: 1989-91, Stock Return 1989-91, Industry-adjusted return on capital 1989-91, Industry-adjusted stock return 1989-91	CEO tenure	<ol style="list-style-type: none"> 1. The relationship between leadership structure and performance indicators is inconsistent. The authors suggest that the prevalence of separated leadership is best viewed as a succession strategy (passing the button)

Carapeto, Lasfer and Machera (2005)	1995-2003	119 announcements to split and 49 to combine leadership of UK firms	CAR, Q ratio, ROE	None	<ol style="list-style-type: none"> 1. Split announcement is positively related to abnormal return 2. Combined announcement is negatively related to abnormal return 3. Split and combined announcement is not related the performance improvement 2 years after the decision 4. ROE before announcement is positive implying that the decision to split the roles of the CEO and COB is not driven by poor performance
Chen et al. (2006)	1999-2003	169 fraud investigations of China Listed firms	Company fraud	Outsider directors, board meeting, directors tenure, ownership concentration and owners identity	<ol style="list-style-type: none"> 1. Combined leadership has insignificant relationship with fraud
Coles, McWilliams and Sen (2001)	1984-1988	144 large US firms	Cumulative abnormal return	Outsider directors, insiders ownership and blockholders	<ol style="list-style-type: none"> 1. Truly independent leadership is related to return 2. Report substitutability effect between independent leadership and the fraction of outsider directors suggesting that board with independent leadership and greater outsider representation might face information flow problem
Dahya, Lonie and Power (1996)	1989-1992	76 UK firms	Average abnormal stock returns		<ol style="list-style-type: none"> 1. Reported significant negative relationships
Daily and Dalton (1992)	1990	100 US firms in Inc. magazine	ROA, ROE, P/E ratio	Outsider directors and founder involvement in management	<ol style="list-style-type: none"> 1. CEO duality is insignificantly associated with firm performance
Daily and Dalton (1993)	1988	186 small US firms	ROA, ROE, P/E ratio	Outsider directors and founder involvement in management	<ol style="list-style-type: none"> 1. CEO duality is insignificantly related to all performance indicators

Daily and Dalton (1994)	1972–1982	57 matched pairs of bankrupt and survivor US firms	Corporate bankruptcy	Outsider directors	<ol style="list-style-type: none"> 1. Bankrupt firm have greater incidence of CEO duality than survivor firm 2. Reported a significant positive interaction effect for CEO duality and the proportion of affiliated directors
Davidson, Worrell and Cheng (1990)	1986	157 events by Fortune 500 firms	Cumulative abnormal returns	None	<ol style="list-style-type: none"> 1. Reported significant positive relationships between CEO duality and firm performance 2. The author's hypotheses focused on the announcements of consolidation of board leadership structure as an executive succession mechanism.
Dehaene, De Vuyst and Ooghe (2001)	1995	Pairing of 61 listed and 61 non listed firms	ROA and ROE	Outsider directors and board size	<ol style="list-style-type: none"> 1. Duality have positive impact on ROA
Desai , Kroll and Wright (2003)	1980-1990	149 firms announcing acquisitions	Cumulative abnormal Return	Outsider directors, outsider directors ownership, CEO compensation	<ol style="list-style-type: none"> 1. Separated leadership demonstrate positive CAR and combined leadership demonstrate negative CAR 2. Leadership structure moderate the association between the fraction of outsider directors and return 3. The authors offer competing hypotheses derived from agency and stewardship theory
Faccio and Lasfer (2000)	1996-1997	1650 firms of London Stock Exchange firms	Q ratio	Outsider directors, board size, management ownership	<ol style="list-style-type: none"> 1. Separated leadership firms have higher Q. This result only robust with low level of managerial ownership

Fosberg, and Nelson (1999)	1989-1992	54 firms with stable leadership	Operating income to asset ratio Market to book value	None	<ol style="list-style-type: none"> 1. The result shows that separated leadership is associated with subsequent performance improvement while duality is insignificantly related to changes in firm performance. 2. The authors' offer two competing hypothesis: agency and normal succession theory
Haniffa and Hudaib (2006)	1996-2000	347 firms (1735 observation) of Kuala Lumpur Stock Exchange	Q ratio, ROA	Outsider directors, board size, multiple directorships, ownership by directors and top five owners	<ol style="list-style-type: none"> 2. CEO duality is insignificantly related to Q ratio and negatively related to ROA.
Krivogorsky (2006)	2000-2001	81 EU firms listed in US	ROA, ROE, MTB	Outsider directors, ownership by management, controlling family, and blockholder	<ol style="list-style-type: none"> 1. Combined leadership is negatively related to firm performance
Pi and Timme (1993)	1987-1990	112 US commercial bank holding companies	ROA, Cost efficiency	Managerial ownership	<ol style="list-style-type: none"> 1. Combined leadership is negatively related to firm performance. 2. Reported a significant negative interaction effect for CEO duality and CEO ownership
Schmid and Zimmermann (2008)	2002	152 Swiss listed firms	Q ratio	Outsider directors, board size, ownership by management, directors, and blockholder	<ol style="list-style-type: none"> 1. Reported insignificant relationships 2. Entrenchment effect of combined leadership might be mitigated by higher incentive alignment of insider ownership
Tian and Lau (2001)	1996-1997	113 Chinese listed firms	<ol style="list-style-type: none"> 1. Return on assets 2. Return on equity 3. ratio of owner equity to total assets 	Outsider directors, board size, ownership by state	<ol style="list-style-type: none"> 1. the effect of combined leadership on firm performance is positive 2. The author offered competing hypotheses derived from agency and stewardship theories

Vafeas and
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1994

250 UK firms

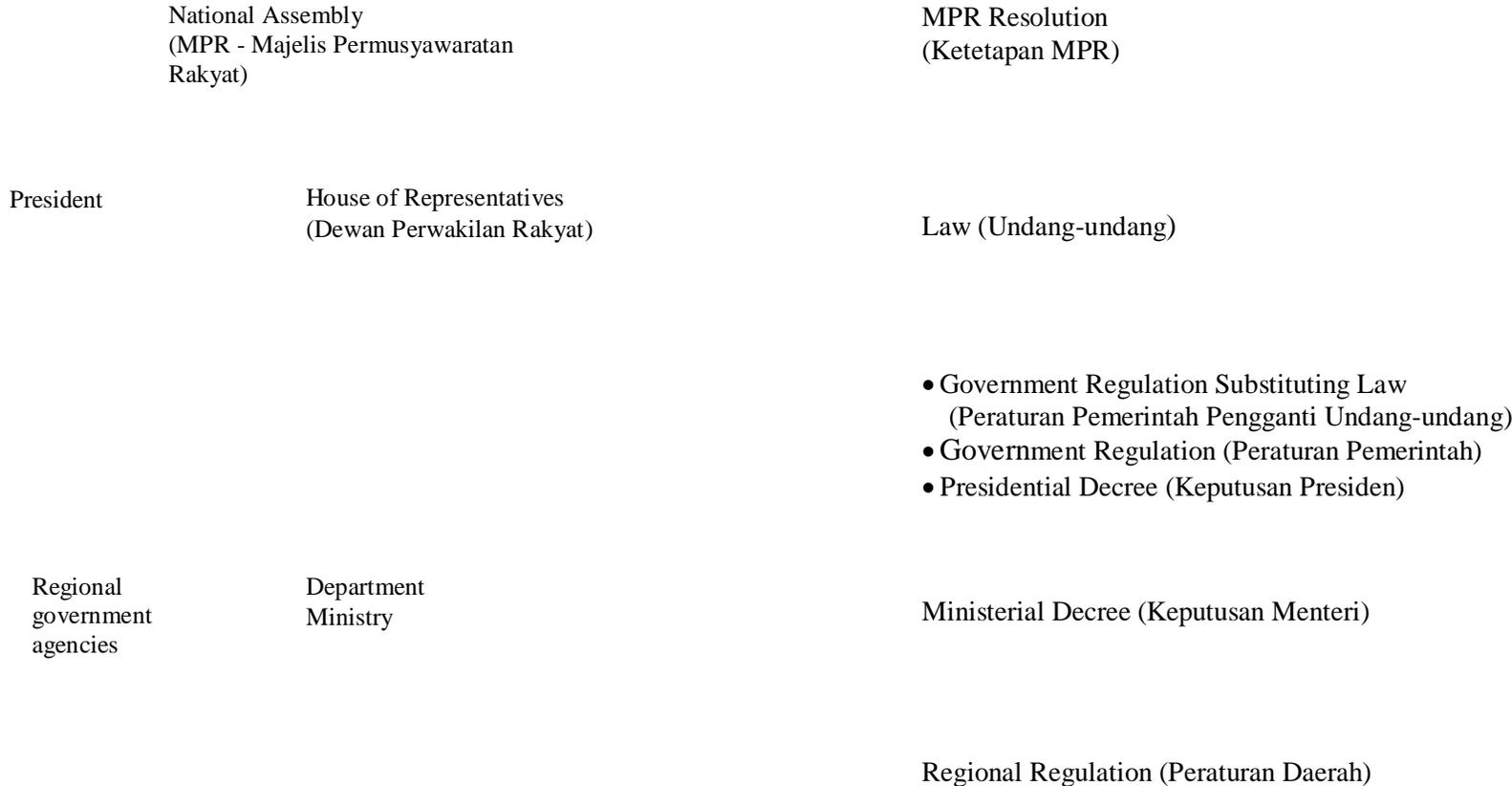
Market to book value

Outsider directors, insider
directors ownership

1. CEO duality is insignificant predictor of
firm performance

Appendix 3

Figure 14: Indonesian Legislation System



Sources: TAP MPR No: III/MPR/2000

Appendix 4: Normal Probability Plot and Standardized Residual Scatterplot of Regressions Analyses

Figure 15: Normal Probability Plot of OLS Regression of ROA2003 on Board Composition

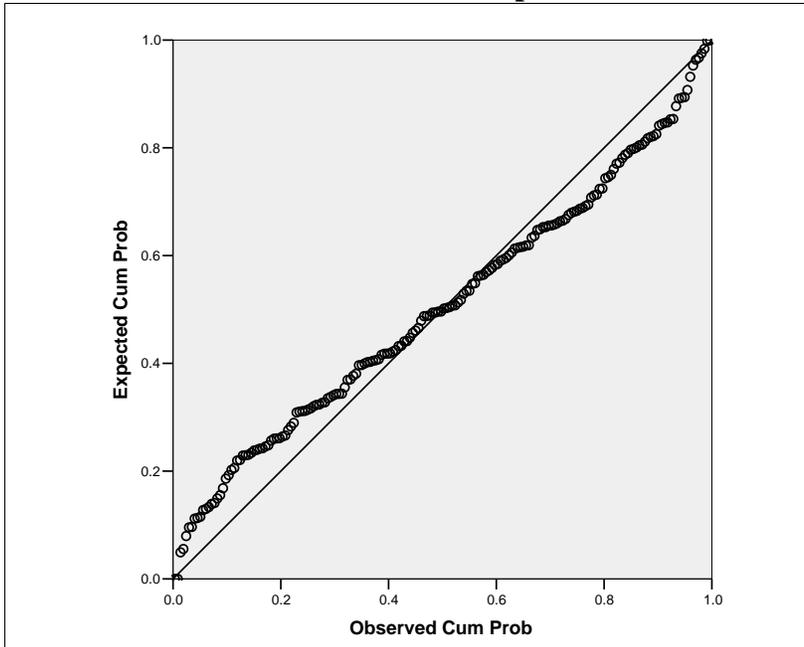


Figure 16: Standardized Residual Scatterplot of OLS Regression of ROA2002 on Board Composition

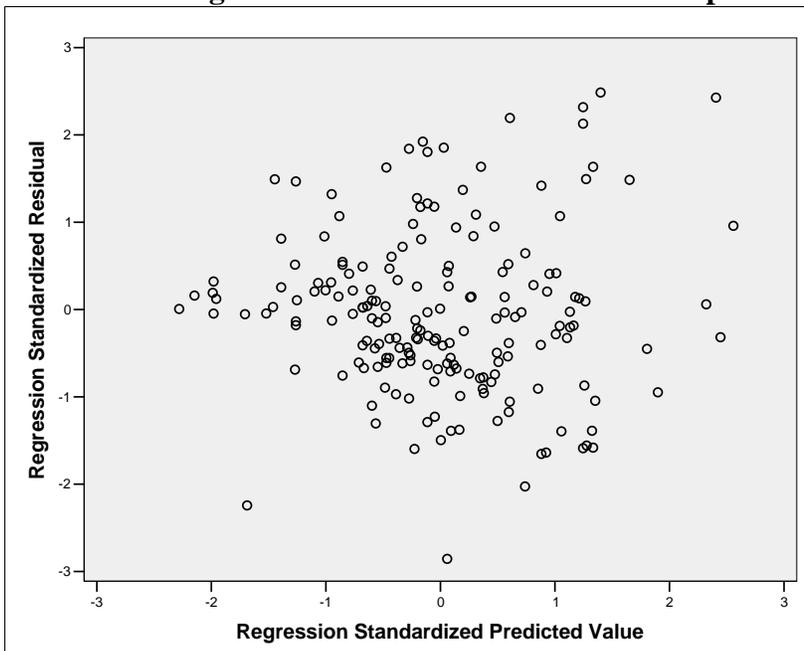


Figure 17: Normal Probability Plot of OLS Regression of ROA on Board Composition and Controlling Family Shareholding

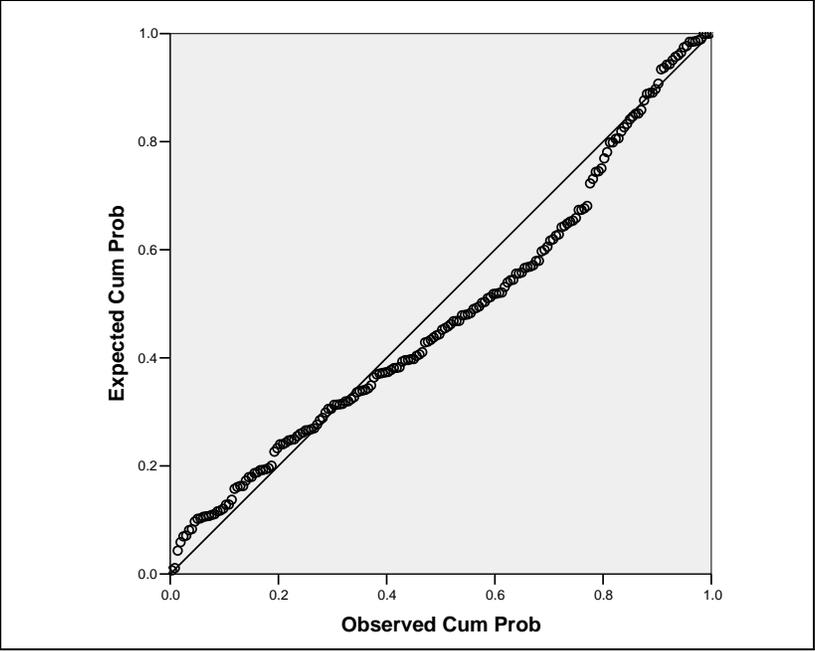


Figure 18: Standardized Residual Scatterplot of OLS Regression of ROA2002 on Board Composition and Controlling Family Shareholding

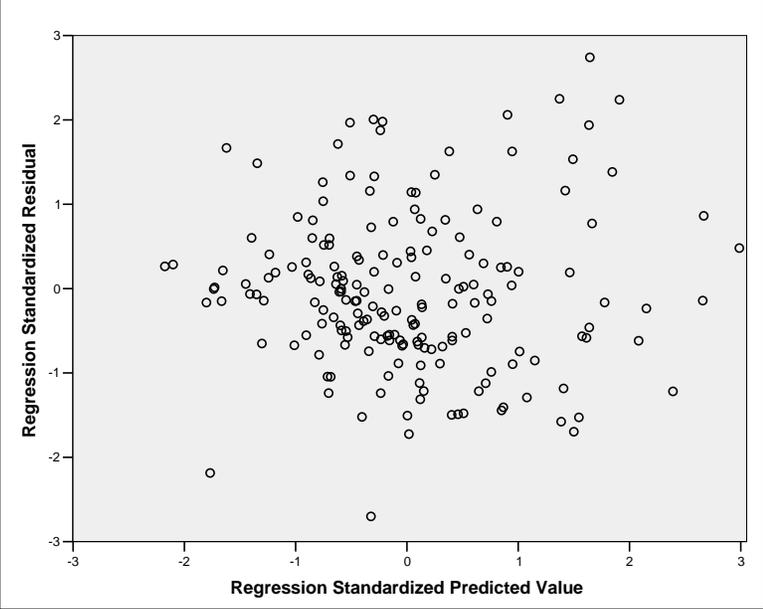


Figure 19: Normal Probability Plot of OLS Regression of ROA on Board Composition and Controlling Family Involvement in Management

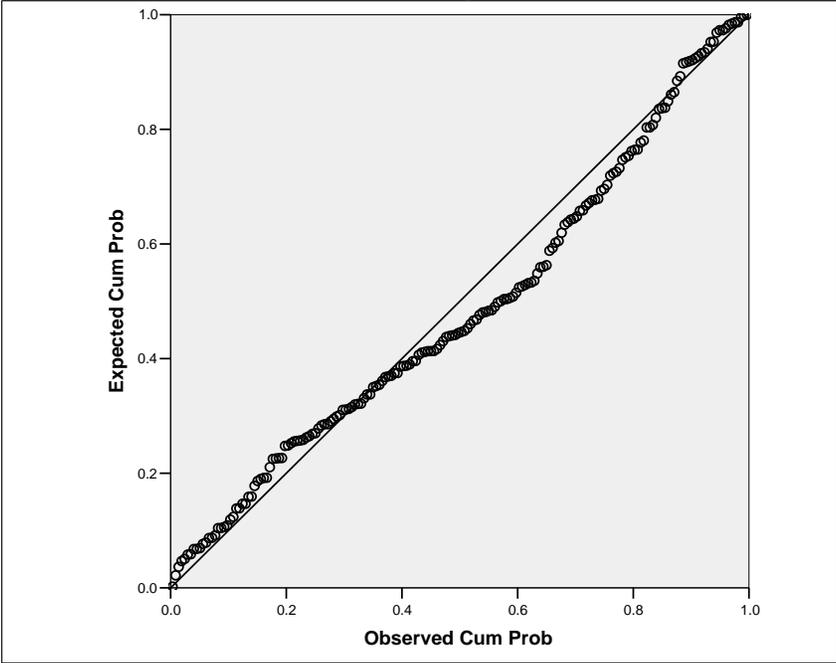


Figure 20: Standardized Residual Scatterplot of OLS Regression of ROA2002 on Board Composition and Controlling Family Involvement in Management

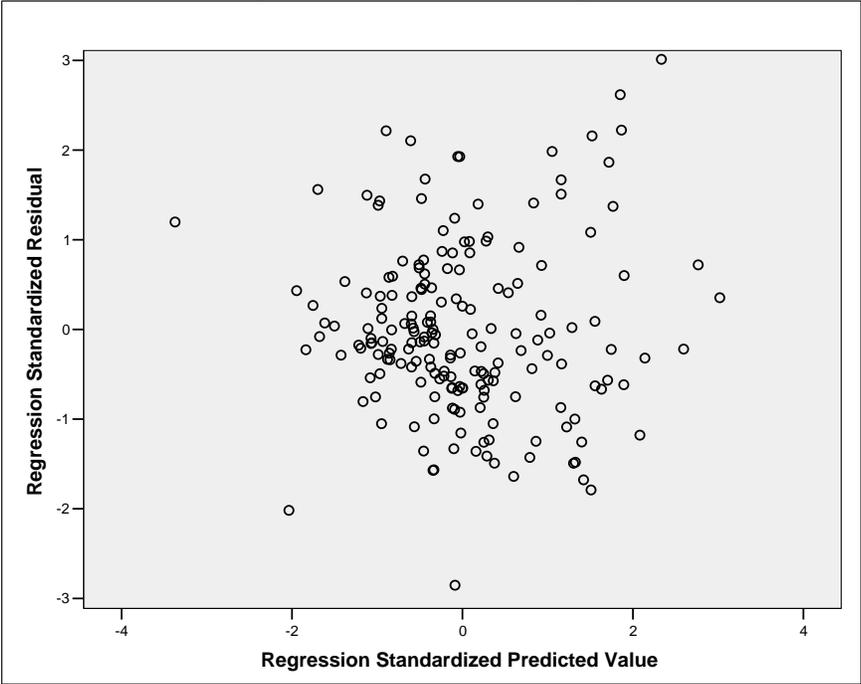


Figure 21: Normal Probability Plot of OLS Regression of ROA on Board Composition and Controlling Family Involvement on the Board

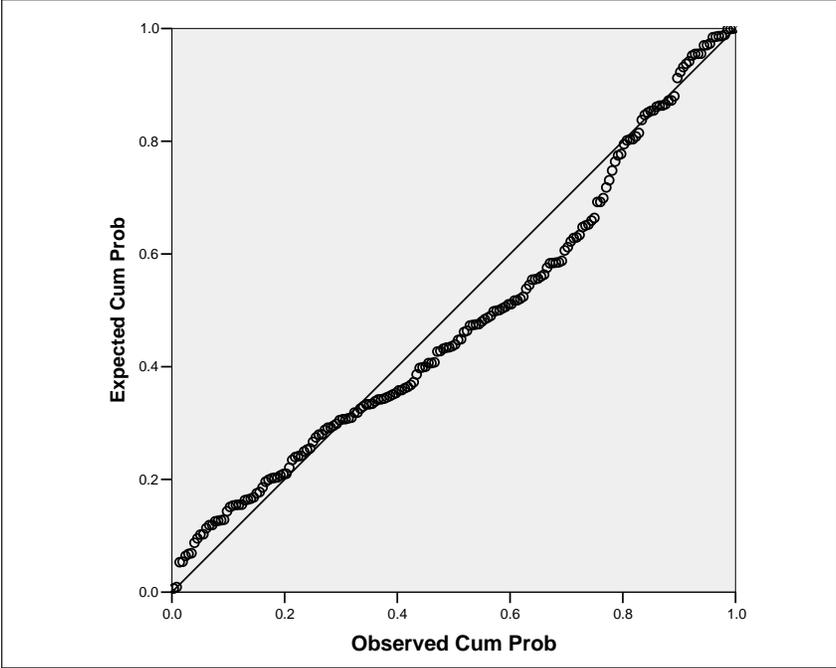


Figure 22: Standardized Residual Scatterplot of OLS Regression of ROA2002 on Board Composition and Controlling Family Involvement on the Board

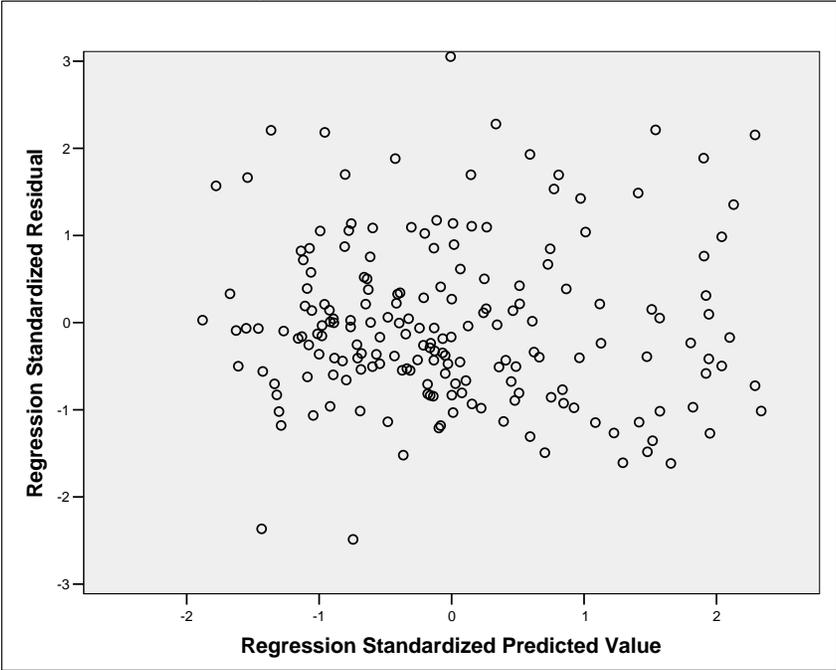


Figure 23: Normal Probability Plot of OLS Regression of ROA on Board Composition and Controlling Family Ownership, the Involvement in Management and on the Board

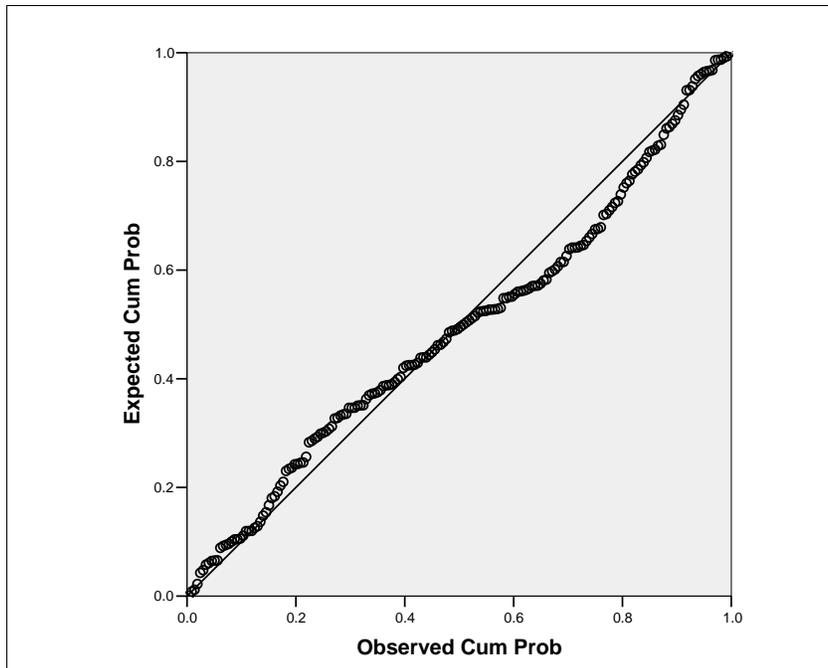


Figure 24: Standardized Residual Scatterplot of OLS Regression of ROA2002 on Board Composition and Controlling Family Ownership, the Involvement in Management and on the Board

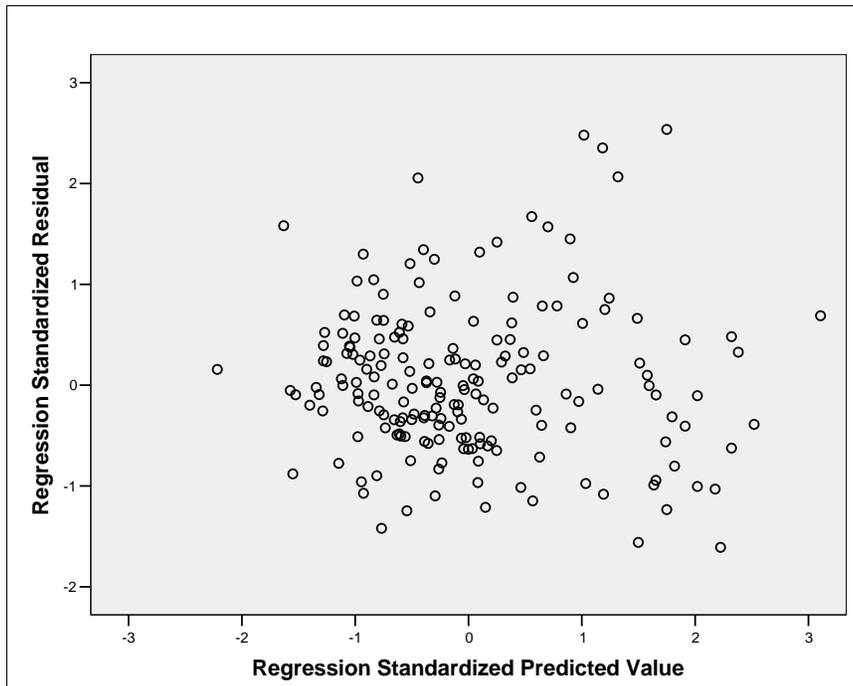


Figure 25: Normal Probability Plot of OLS Regression of ROA on Board Composition and Controlling Family Ownership, the Involvement in Management and on the Board and Control Variables

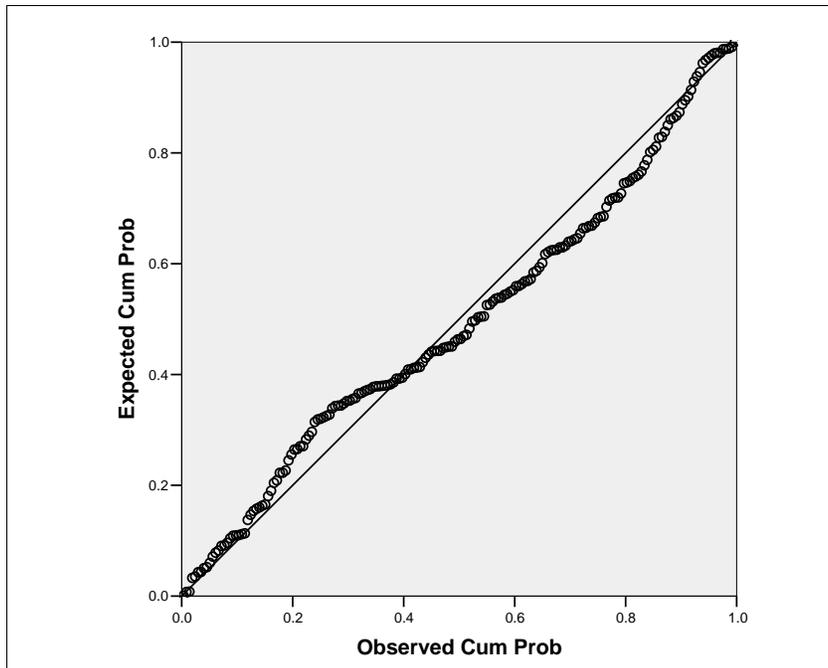


Figure 26: Standardized Residual Scatterplot of OLS Regression of ROA on Board Composition and Controlling Family Ownership, the Involvement in Management and on the Board and Control Variables

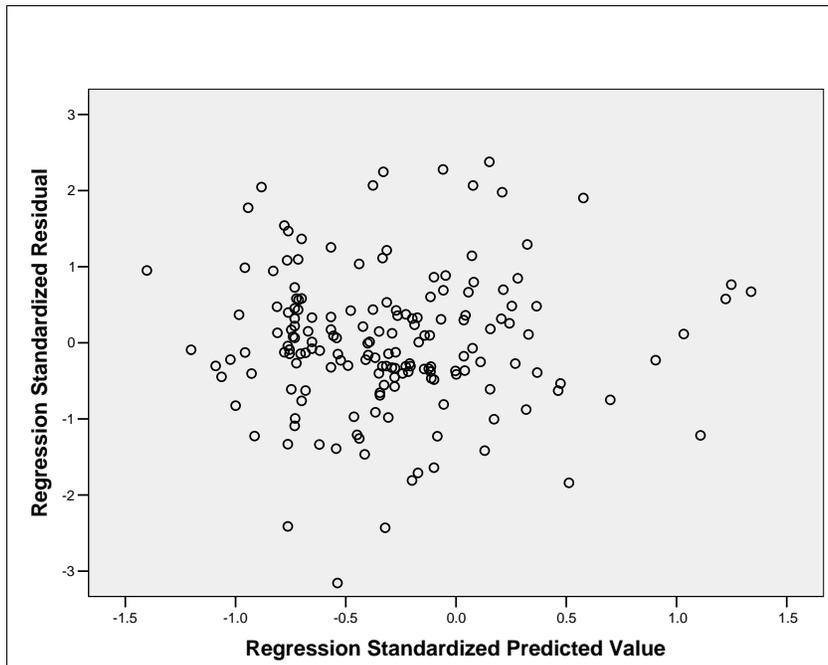


Figure 27: Normal Probability Plot of OLS Regression of ROA on Board Composition and Blockholders Ownership, Controlling Family Involvement in Management and on the Board and Control Variables

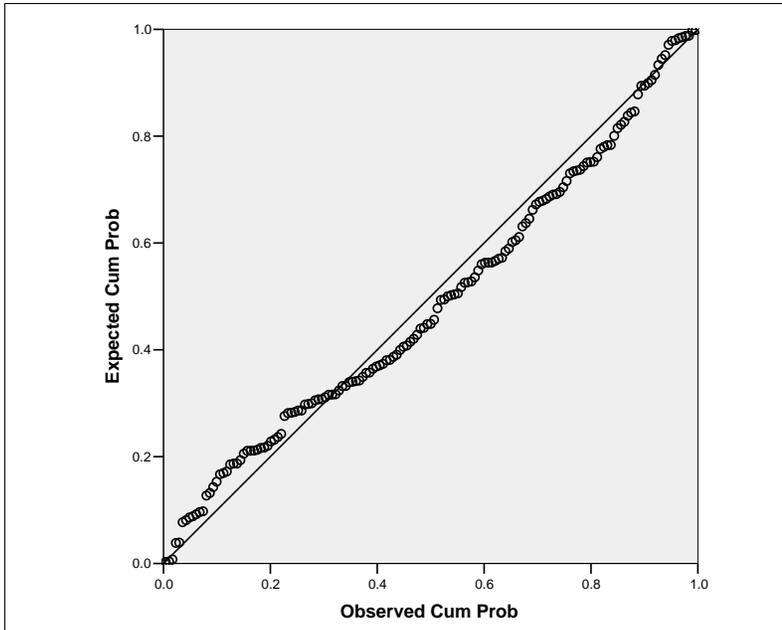


Figure 28: Standardized Residual Scatterplot of OLS Regression of ROA on Board Composition and Blockholders Ownership, Controlling Family Involvement in Management and on the Board and Control Variables

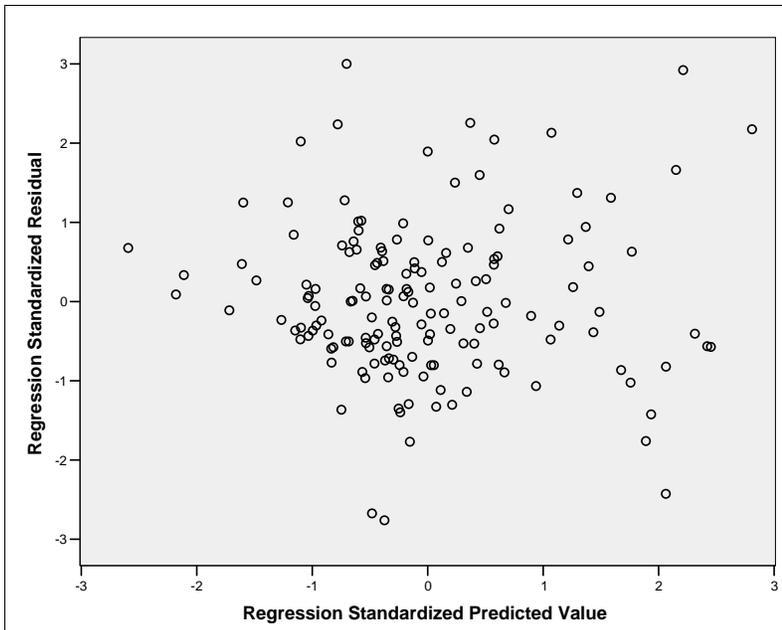


Figure 29: Normal Probability Plot of OLS Regression of ROE on Board Composition

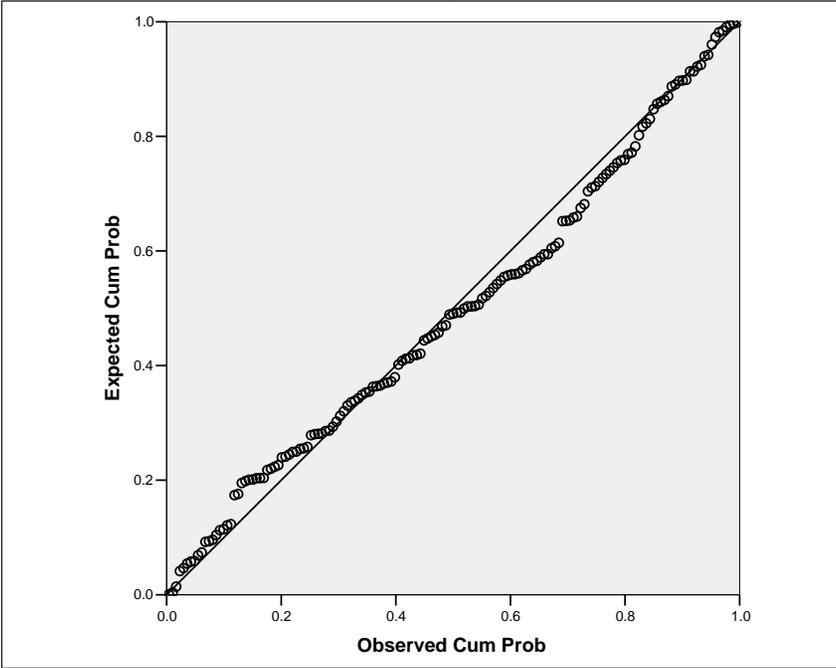


Figure 30: Standardized Residual Scatterplot of OLS Regression of ROE on Board Composition

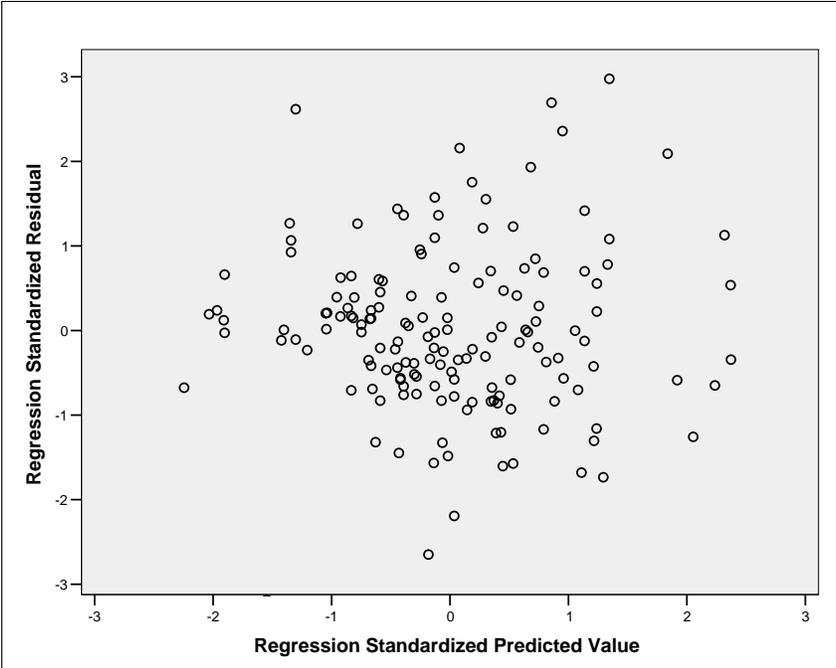


Figure 31: Normal Probability Plot of OLS Regression of ROE on Board Composition and Controlling Family Ownership

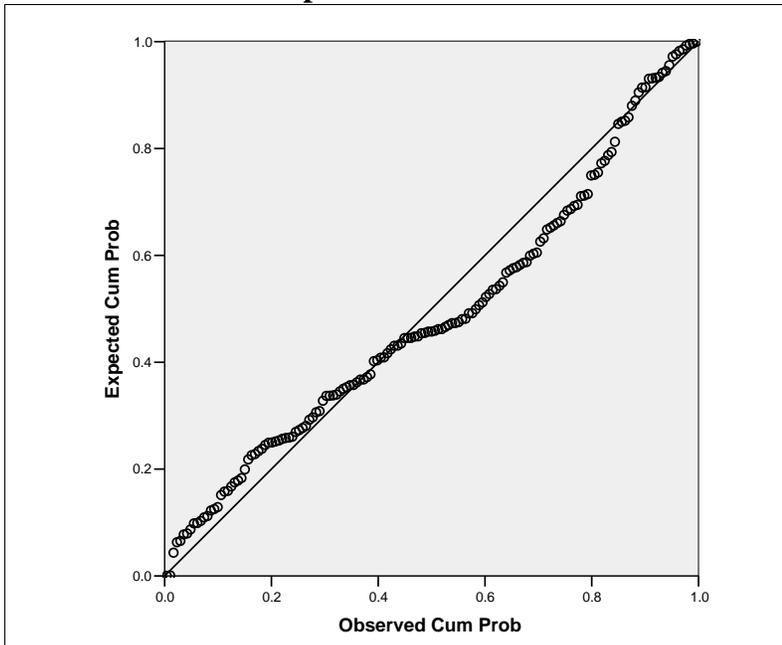


Figure 32: Standardized Residual Scatterplot of OLS Regression of ROE on Board Composition and Controlling Family Ownership

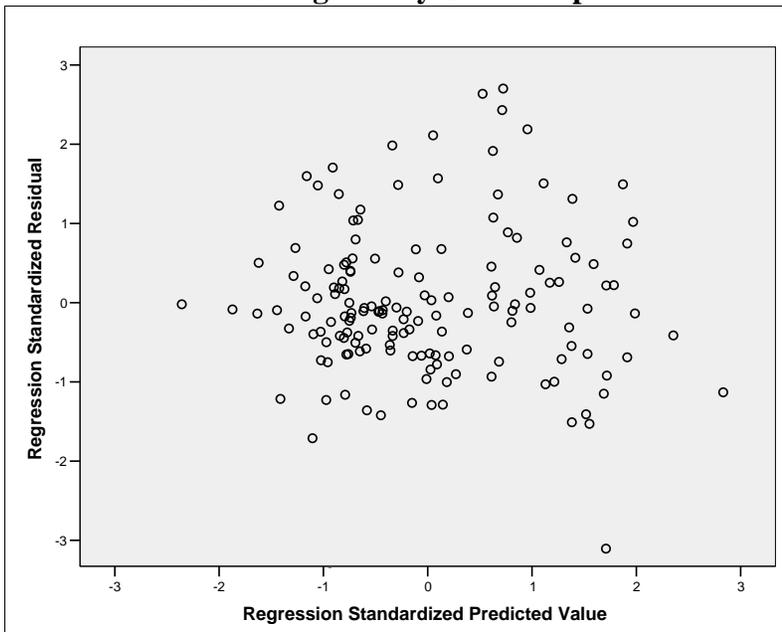


Figure 33: Normal Probability Plot of OLS Regression of ROE on Board Composition and Controlling Family Involvement in Management

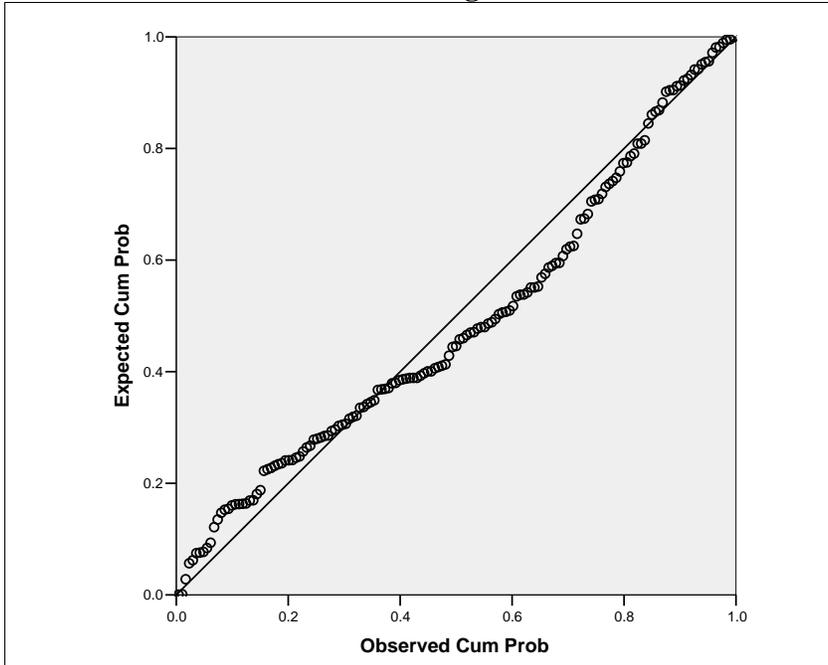


Figure 34: Standardized Residual Scatterplot of OLS Regression of ROE on Board Composition and Controlling Family Involvement in Management

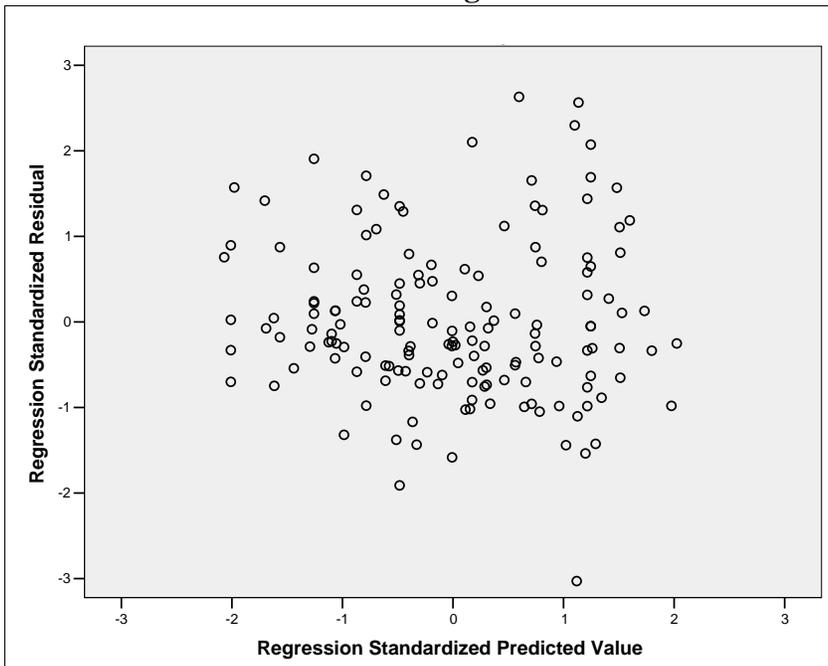


Figure 35: Normal Probability Plot of OLS Regression of ROE on Board Composition and Controlling Family Involvement on the Board

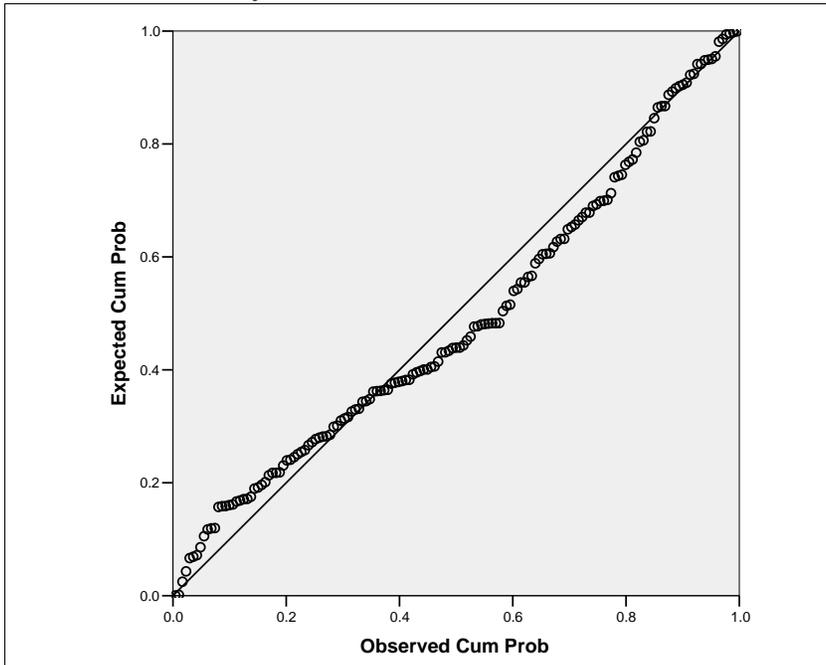


Figure 36: Standardized Residual Scatterplot of OLS Regression of ROE on Board Composition and Controlling Family Involvement on the Board

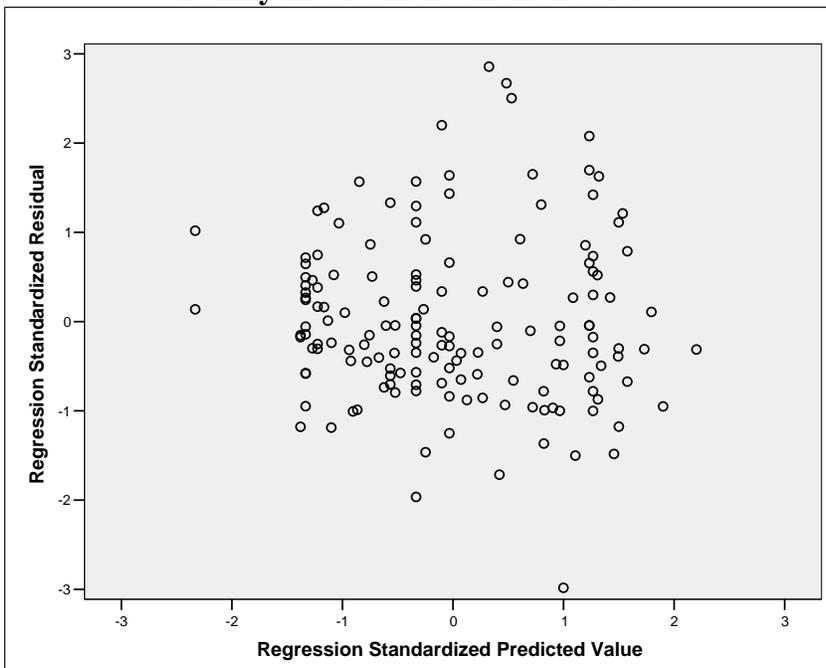


Figure 37: Normal Probability Plot of OLS Regression of ROE on Board Composition and Controlling Family Ownership and the Involvement in Management and on the Board and Control Variables

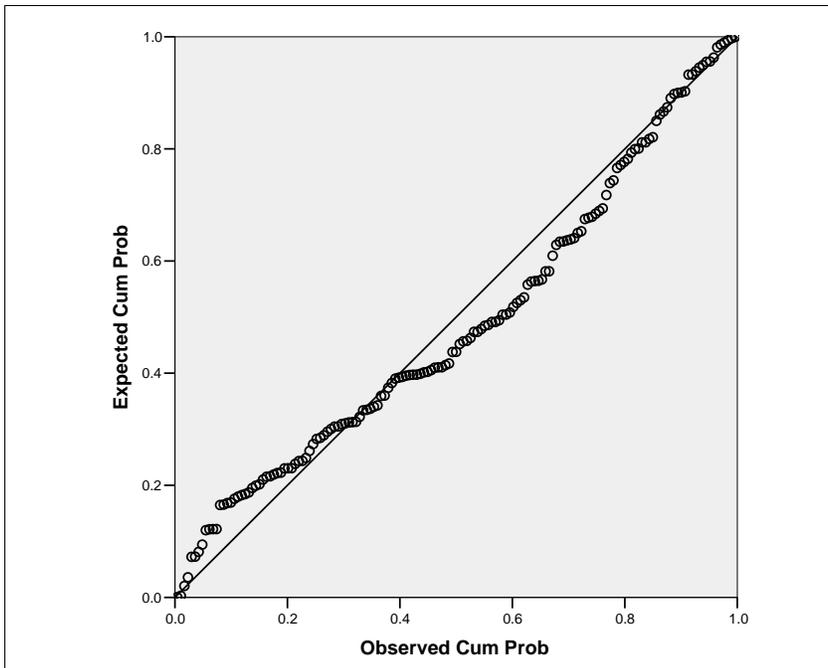


Figure 38: Standardized Residual Scatterplot of OLS Regression of ROE on Board Composition and Controlling Family Ownership, the Involvement in Management and on the Board and Control Variables

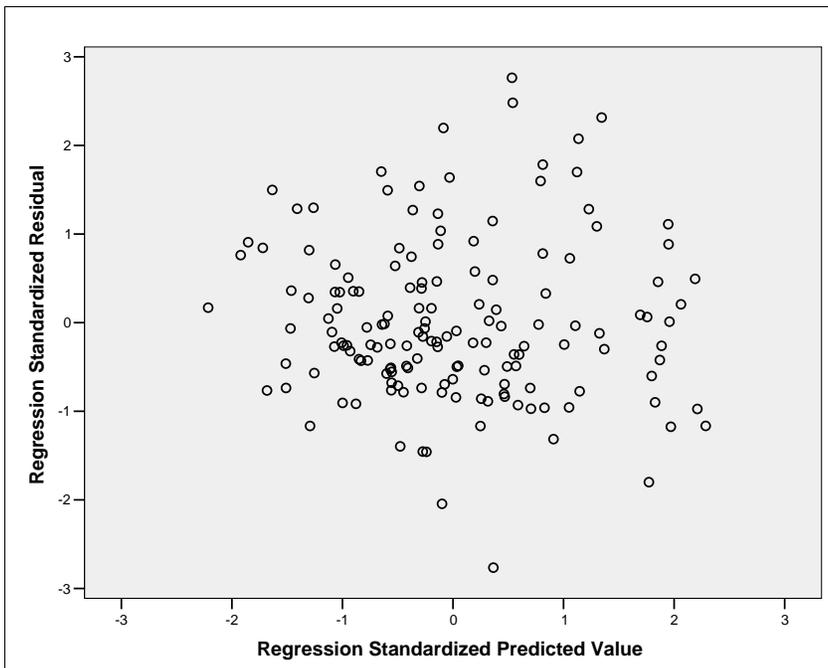


Figure 39: Normal Probability Plot of OLS Regression of ROE on Board Composition and Blockholders Ownership, Controlling Family Involvement in Management and on the Board and Control Variables

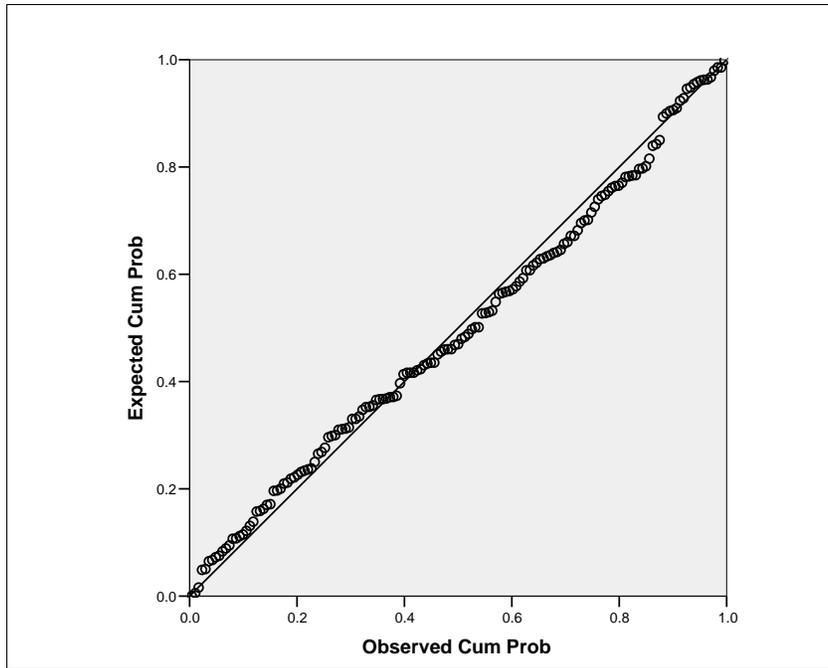


Figure 40: Standardized Residual Scatterplot of OLS Regression of ROE on Board Composition and Blockholders Ownership, Controlling Family Involvement in Management and on the Board and Control Variables

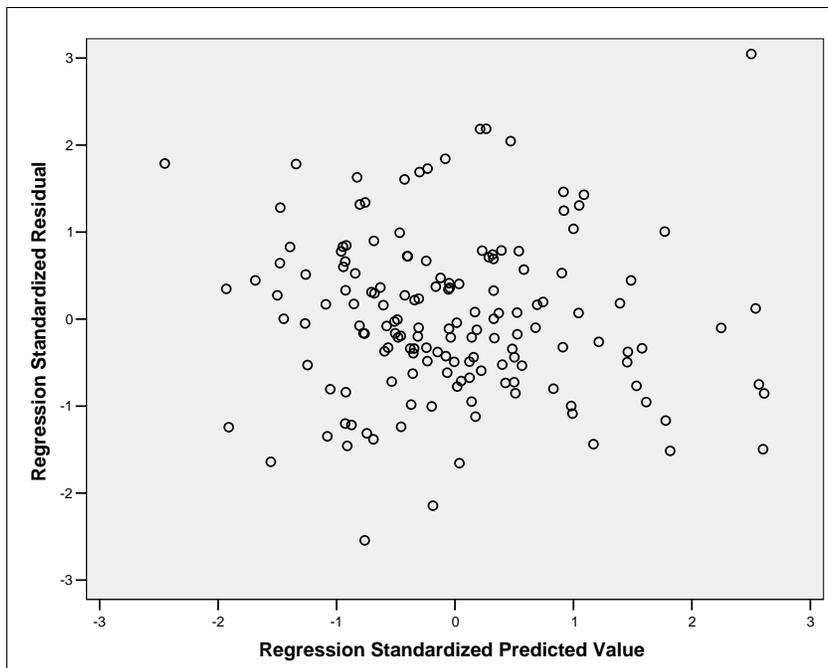


Figure 41: Normal Probability Plot of OLS Regression of Changes in ROA on Changes in Board Composition, Controlling Family Ownership, Blockholders Ownership, Controlling Family Involvement in Management and on the Board

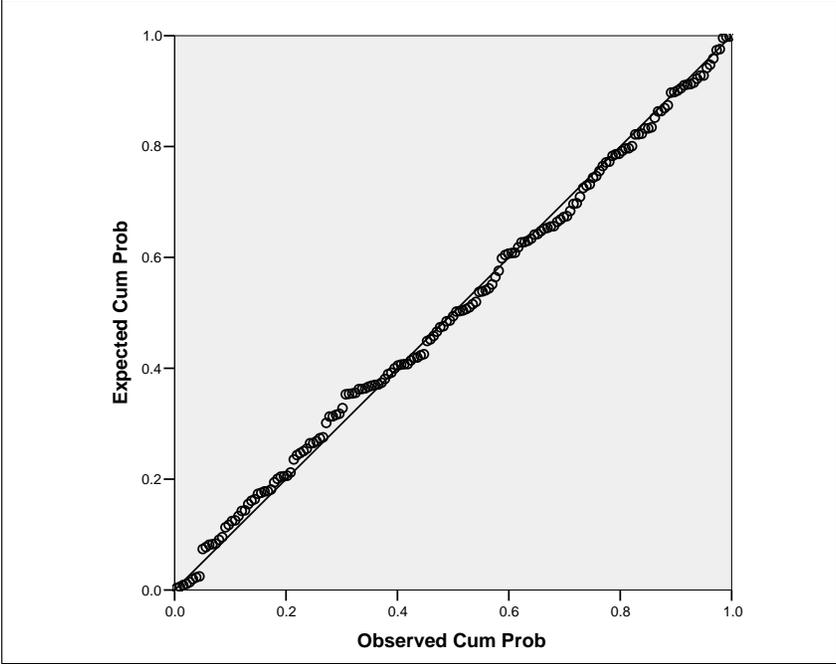


Figure 42: Standardized Residual Scatterplot of OLS Regression of Changes in ROE on Changes in Board Composition and Controlling Family Ownership, Blockholders Ownership, Controlling Family Involvement in Management and on the Board

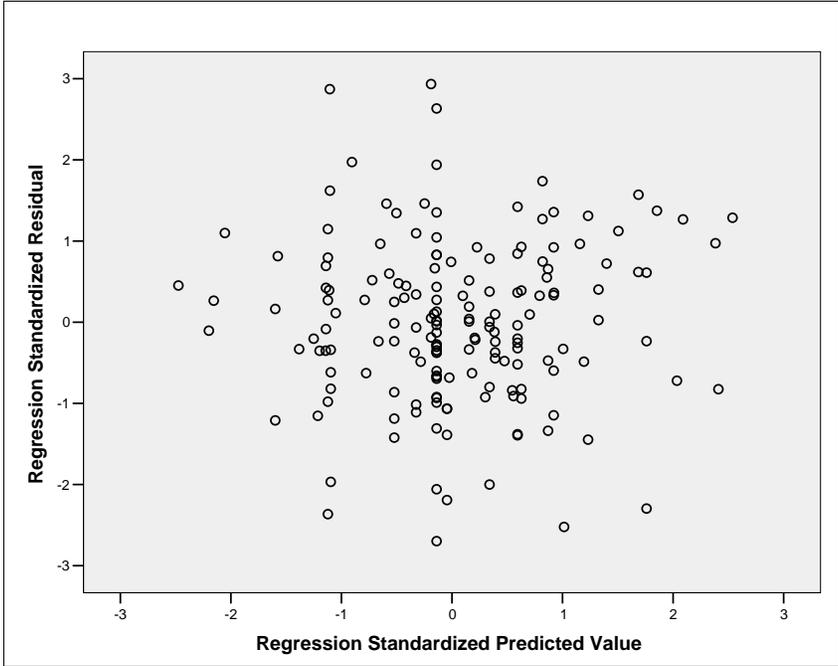


Figure 43: Normal Probability Plot of OLS Regression of Changes in ROA on Changes in Board Composition and Controlling Family Ownership

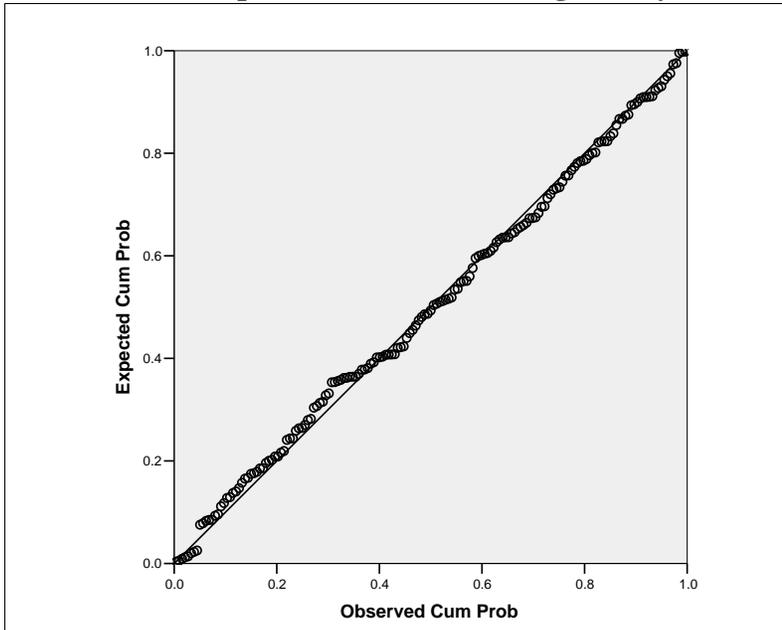


Figure 44: Standardized Residual Scatterplot of OLS Regression of Changes in ROE on Changes in Board Composition and Controlling Family Ownership

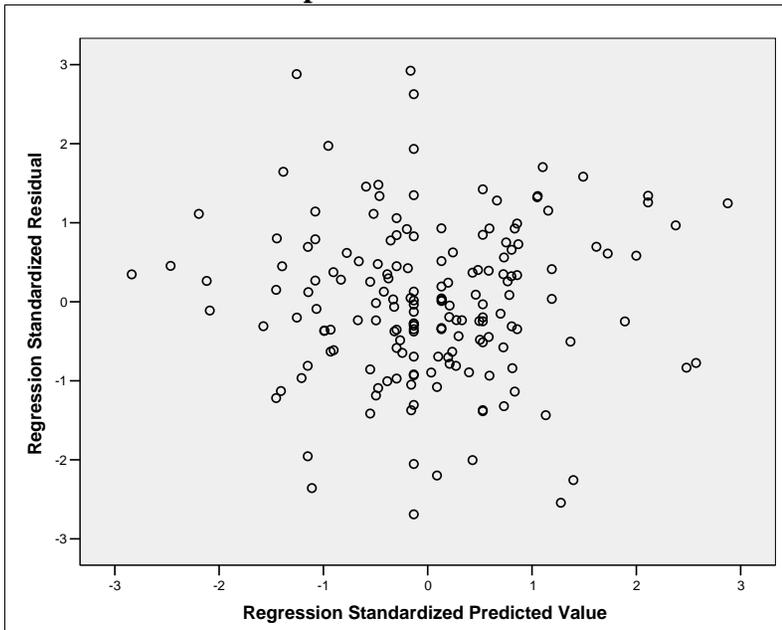


Figure 45: Normal Probability Plot of OLS Regression of Changes in ROA on Changes in Board Composition and Controlling Family Involvement in Management

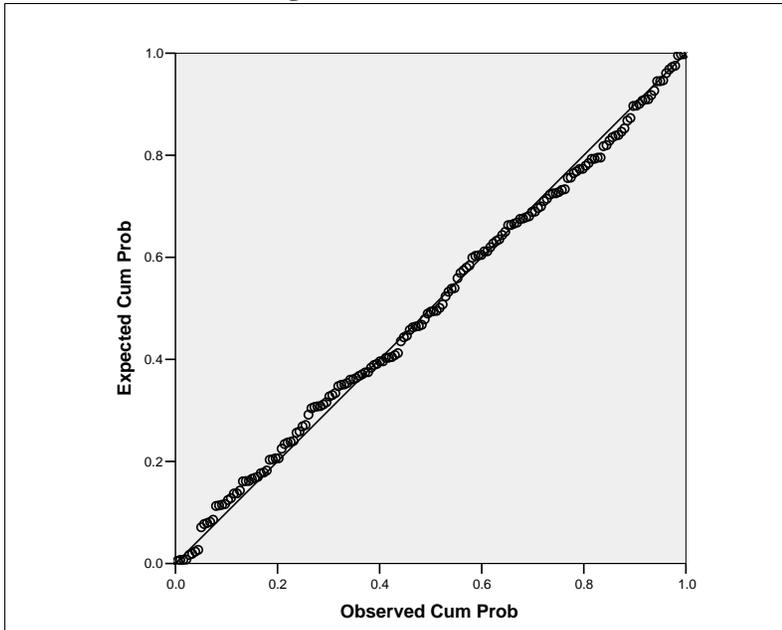


Figure 46: Standardized Residual Scatterplot of OLS Regression of Changes in ROE on Changes in Board Composition and Controlling Family Involvement in Management

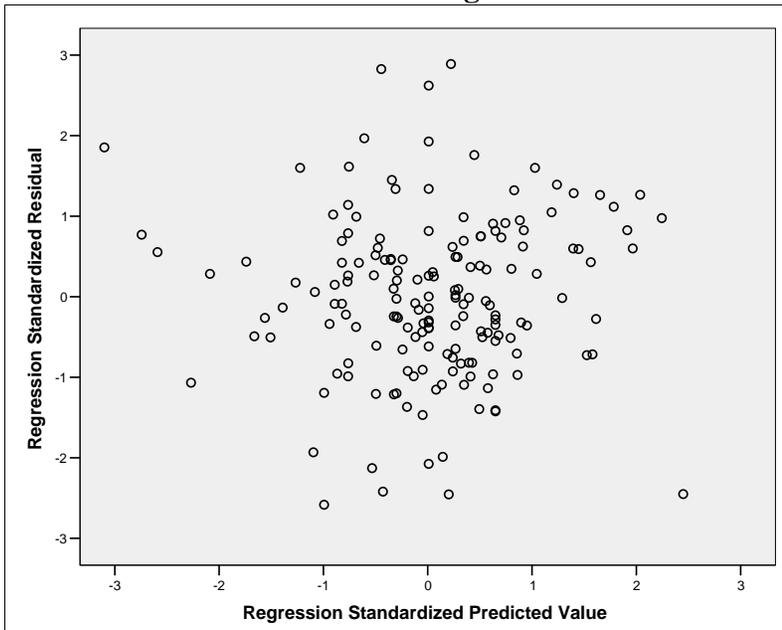


Figure 47: Normal Probability Plot of OLS Regression of Changes in ROA on Changes in Board Composition and Controlling Family Involvement on the Board

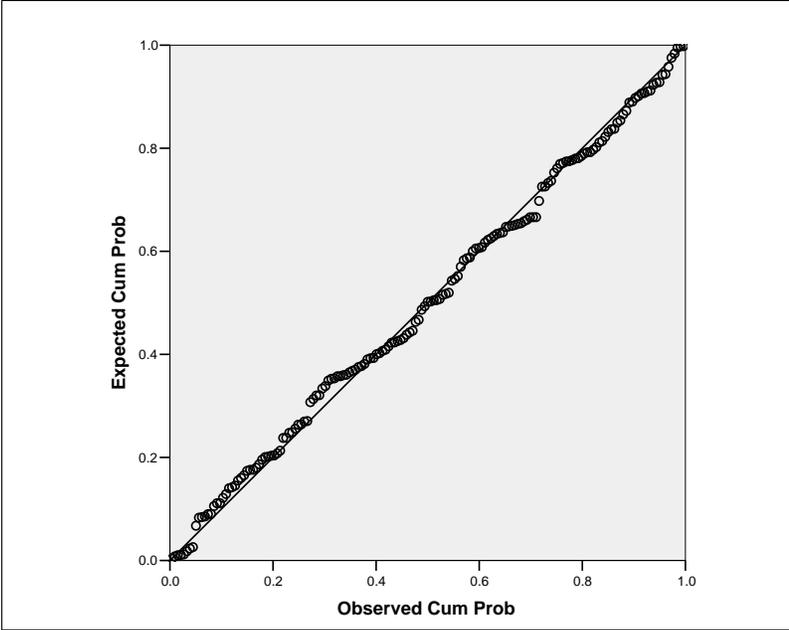


Figure 48: Standardized Residual Scatterplot of OLS Regression of Changes in ROE on Changes in Board Composition and Controlling Family Involvement on the Board

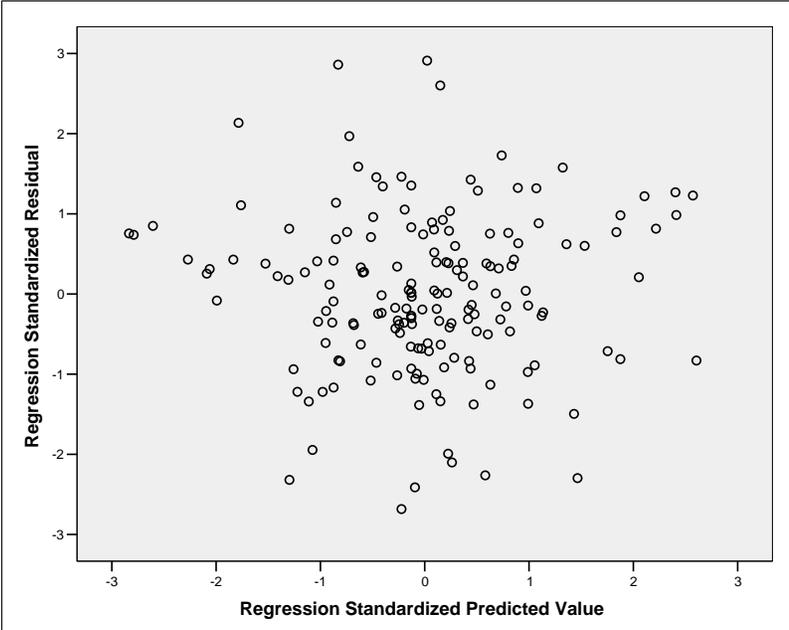


Figure 49: Normal Probability Plot of OLS Regression of Changes in ROA on Changes in Board Composition, Blockholders Ownership, the Family Involvement in Management and on the Board

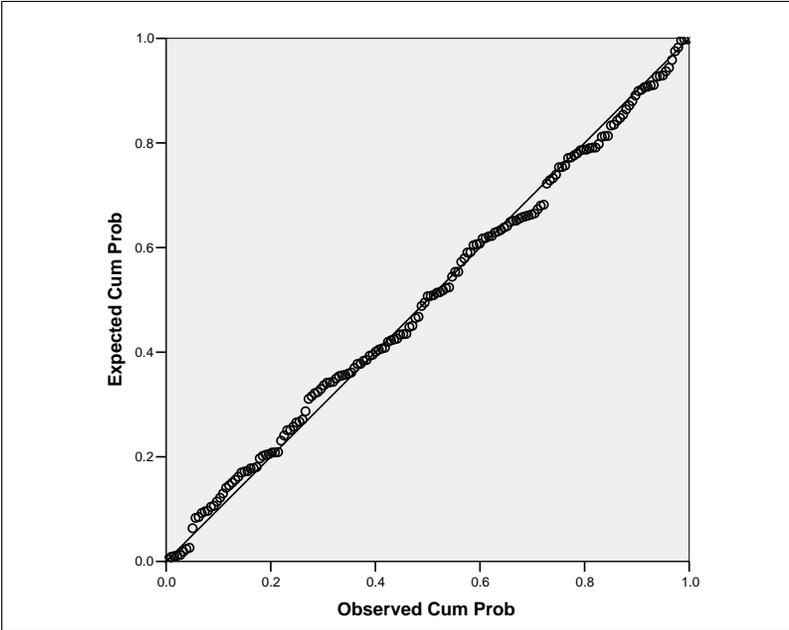


Figure 50: Standardized Residual Scatterplot of OLS Regression of Changes in ROE on Changes in Board Composition, Blockholders Ownership and the Family Involvement in Management and on the Board

