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# Implementation of Good Corporate Governance Mechanisms on Family Firm Performance in Indonesia

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The aim of this study is to examine the relationship of good corporate governance on family firms' performance in Indonesia. This study used 125 of family companies on Indonesia Stock Exchange from 2010 to 2014 as a sample size. This study contributes to literature on family corporate governance and firm performance. Empirical evidence leads the family corporate governance and firm performance with mixed results. This study focuses of companies who have at least 20% shareholders or more which own by families. The findings reveal that board size and debt has a positive relationship with family firm performance. Larger board size is give more resource and has high solving problem capabilities than smaller board of director. However, board commissioner of independent does not contribute to firm value. Further, manager who has high portion managerial ownership would lead these managers concern on personal interest rather than firm's interest. Next, Debt help financial problem in companies while running the business and achieve the high performance and small size of company enhance the firm performance. Further, this finding is to enrich the literatures on family corporate governance and firm performance especially in Indonesia.

**Keywords:** Board Structure, Two-Tier System, Firm Performance, Family Companies, Indonesia.

## 1. INTRODUCTION

Corporate governance is a framework which ensuring fair treatment for each of stakeholder interest and creating the accountability and transparency among of them.<sup>19</sup> During implement the corporate governance, the companies' stakeholder often faces a conflict.<sup>11</sup> The corporate governance deals with collective action in problems facing a firm's alternative stakeholders.<sup>2</sup> To resolve the conflicts, companies often rely on the role of the largest shareholder, which combines ownership and property rights to influence decisions. Majority family business ownership is the largest shareholder in a company.<sup>13</sup> Empirical evidence shows that the percentages family ownership of the company was significant impact on the business organization in the world.

Family business support successful economic improvement in most countries around the world especially in Asia. Several empirical study in Asia suggests that family firms in Malaysia, Hong Kong, Australia, Singapore, Taiwan and China show high company performance.<sup>1,2,4</sup> In this study, we focus on the family business. It is defined as to have equity or shares cut-off point of 20% and be the largest shareholders in a company.<sup>1,3</sup>

Family firms have great impact on Indonesia economy because family business does contribute 45 to 70% gross domestic product.<sup>5</sup> Based on Jakarta group consulting in 2014, it was

reported that 90% to 95% of companies listed in Indonesia Stock Exchange were family businesses. Some of the well-known Indonesian family firms are Lim Sui Liong owner of Salim group, Kris Wiluan owner of Citra Tubindo Tbk, Ciputra owner of Ciputra group and Abidin owner of Satnusa group. These companies are still owned by the founder. Nowadays, many large companies have become diversified, but there are still small companies such as Primagama, Amaris hotel, and Ayam Penyet Ria that keep their business in the primary sector.<sup>5</sup>

This contribution of this study is that it extends the knowledge on Indonesia corporate governance practice. Further, this study will provide useful information on family businesses performance and can be compared with other countries in Asia. For practical contribution, the results are expected to provide meaningful inputs to the regulators in Indonesia such as *Bapepam-LK* (capital market and non-bank financial sector regulators), academicians in Indonesia, owners of family business and the party who is designing the rules and regulations for family controlled companies.

This study presented as follows: The introduction, motivation and problem statement of the study are highlighted in first section. Then, follow with literature reviews that deliberate the theories of corporate governance mechanisms, and firm performance. Next, theoretical framework and hypothesis development are develop. Follow with the research methodology. The research

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findings and discussion are explained in the following section. Finally is the conclusion on the research findings, limitation of the study and recommendations for future study.

## 2. THEORIES OF CORPORATE GOVERNANCE

Most of the top management in Indonesia companies is not the owner of the company. In fact, most of them have only a small portion of the shares in the companies which they manage. The real owners elect a board of directors who are the managers to run the day-to-day activities of the company. Once these managers are employed, the questions such as “How does director can be trusted?”, “Are they putting themselves or the company as the first priority?” is often arise. There are several theories developed to answer these questions. There are agency theory and stewardship theory.

### 2.1. Agency Theory

Agency theory describes the organization as a contractual relationship between the perpetrator (principal) and the personal interests of agents who are the managers.<sup>15</sup> Agency theory concern is on the separation of ownership and control that causes the principal-agent problems. The agents will focus more on their personal interest rather than stakeholder interest.<sup>6</sup> Firm that are survive are those firms that can best solve the problems in term of minimizing agency cost.<sup>15</sup>

### 2.2. Stewardship Theory

Stewardship theory provides another model of management, where the agent or manager is expected to be a good manager who will try his/her best to achieve the shareholder interests and company's goals. The stewardship theory focuses on the behaviour of the directors. The characteristic of steward behaviour are pro-organization, collective, and has a high usability for the company. These managers will not seek for their personal interest because managers prefer to achieve organizational goals.<sup>8</sup> Stewardship theory consider a strong relationship between the agent and company's goal, therefore the manager will protects the shareholder interest and maximize the wealth of shareholder through the company's performance.<sup>9</sup>

## 3. CORPORATE GOVERNANCE AND FIRM PERFORMANCE IN INDONESIA

The financial crisis in Indonesia since 1997 to 1998 had a dramatic impact on social, economic and political. The crisis has brought the Rupiah down by almost 80% and dramatically increased the Indonesian poverty. The recession in Indonesia was fueled by many institutional weaknesses, among which the lack or inadequate enforcement of the central bank's regulations, irregular banking practices and the extremely poor financial regulation.<sup>5</sup>

Indonesia had done a lot of initiatives and efforts to implement good corporate governance, both from government and private. Those initiatives and efforts include the establishment of corporate governance institutions, adoption of new laws and amendments of existing ones to support corporate governance

implementation process in the country. More specifically, Indonesia has taken several steps towards improving corporate governance standards and enhancing the legislation. A national committee for Good Corporate Governance has been established in 1999 under the supervision of the Coordinating Minister for Economic Affairs and issued the first Indonesia's Code on Good Corporate Governance in 2001, which was amended in 2006.

Indonesia adopts two tier board systems that separate the board structure into board of director and board of commissioners. The functions of board directors are monitoring the operational of company. On the other hand, the board of commissioners as supervisory board that controlling the actions of board directors. Based on the Indonesian Code on Corporate Governance, this paper examines some elements internal corporate governance mechanisms (board size, independent board of commissioner, and managerial ownership) that may influence the firm's performance (Tobin's Q).

## 4. THEORETICAL FRAMEWORK AND HYPOTHESIS DEVELOPMENT

Based on the discussed literature review, we proposed the framework based on the following variables:

### 4.1. Tobin's Q

Tobin's Q is one of the profitability proxy that is often used as firm performance measurement in the study of corporate governance.<sup>10,11</sup> In this, Tobin's Q (Q) is an indicator of firm performance because Q is usually use by investors to measure the firm performance. Q is defined market equity value and debt divided by total assets. In Indonesia, the market equity value is the value of share price of fiscal year end.

### 4.2. Board Size

Board size is the total member of directors that sits and represent their interests in managing a company.<sup>10,11</sup> Previous study<sup>10</sup> claims that to ensure board effectiveness, the board size should not be too large. The smaller board will enhance the firm performance.<sup>10</sup> However, different results by another study<sup>12</sup> argued that larger boards will increase the firm performance. Based on discussion above, it is hypothesized that:

**HYPOTHESIS 1 (H1).** *There is a relationship between large board size and family firm performance.*

### 4.3. Independent of Board Commissioners

Indonesia adopts two-tier systems that consist of the board of commissioners, and board of directors (person who run the activity). This structure separates the board membership, namely the membership of the board of commissioners as supervisory board and the board of directors as company executives. Companies in Indonesia followed a two-tier system board like Netherlands. Indonesia board structure is different from other Asia countries such as Malaysia<sup>11</sup> which adopt one-tier board.

In family-controlled firms, board commissioners can provide different view strategy,<sup>10,11</sup> create new dimension of experience and knowledge that may not be found and have on family directors.<sup>13</sup> Board commissioners also compromised their familiarity with the family members.<sup>14</sup> Based on discussion above, family companies view the board of commissioners to understand

**Table I. Min, max, mean and standard deviation on family companies.**

Variables	Min	Max	Mean	SD
Q	0.2892	14.883	1.700	1.796
BSIZE	2.000	12.000	4.362	1.851
BCOM	0.143	0.7500	0.406	0.104
MOWN	0.000	0.7000	0.043	0.114
DEBT	0.004	6.4990	0.622	0.561
FSIZE	10.048	13.917	12.098	0.741

better about family company. Therefore, the high number of independent board of commissioners may bring benefit to company. Thus, it can be hypothesized that:

*HYPOTHESIS 2 (H2). There is relationship between large board commissioners independent and family firm performance.*

#### 4.4. Managerial Ownership

Managerial ownership contributes to the alignment of potential different interests between the managers and outside shareholders.<sup>13</sup> High managerial ownership minimise the problem and reduce the agency costs.<sup>10</sup> Managerial ownership helps management to improve their performance by maximising profits and take carefully decision, because the managers will share the profits and bear the risks of decision being made. These conditions will enhance the performance of the company.<sup>15</sup> Based on discussion above, managerial ownership will has a positive impact on firm performance. Thus, it is hypothesized that:

*HYPOTHESIS 3 (H3). There is a relationship between high managerial ownership and family firm performance.*

### 5. DATA AND RESEARCH METHODOLOGY

#### 5.1. Sample Selection

Sample for this study are 125 public listed family companies in Indonesia Stock Exchange. The criteria are that the companies must have 20% shareholding or more (the largest shareholder) and owned by family members. The period of 2010 to 2014 was selected because this study wants to examine the implementation effect of the revised Indonesian Code of Corporate Governance (2006) on family-controlled company. It starts with identify the family businesses listed in Indonesia Stock Exchange. Further, in this study omitted the financial sector because these are highly regulated and have different regulations compare to other non-financial companies.

#### 5.2. Panel Data Regression

This study uses panel data because panel data analysis is a combination of the data time series and cross section. Panel data is robust to several violations of Gauss Markov assumption.<sup>16, 17</sup>

**Table II. Frequency and per cent board size on family companies.**

Year	<3 members		>3 members	
	Freq.	%	Freq.	%
2010	11	8.80	114	91.20
2011	17	13.60	108	86.40
2012	14	11.20	111	88.80
2013	11	8.80	114	91.20
2014	4	3.20	121	96.80

**Table III. Frequency and per cent board commissioners on family.**

Year	<30%		>30%	
	Freq.	%	Freq.	%
2010	5	4.00	120	96.00
2011	4	3.20	121	96.80
2012	5	4.00	120	96.00
2013	4	3.20	121	96.80
2014	3	2.40	122	97.60

Data in this study is gathered from various industries and taken for five years (2010 until 2014).

#### 5.3. Model Specification

For corporate governance mechanisms variables are board size (H<sub>1</sub>), independent of board commissioners (H<sub>2</sub>), and managerial ownership (H<sub>3</sub>). For control variables in this study are debt and firm size.

The model used is as follows:

$$Q_{it} = \alpha_0 + \alpha_1 BSIZE_{it} + \alpha_2 BCOM_{it} + \alpha_3 MOWN_{it} + \alpha_4 DEBT_{it} + \alpha_5 FSIZE_{it} + \varepsilon_{it}$$

Where by;

Q = market value of ordinary shares plus the book value of preferred shares and debt divided by the book value of the total assets.

BSIZE = number of directors on the board.

BCOM = % of independent board of commissioners divided by total board of commissioners.

MOWN = % of shares owned by board of directors divided by total number of shares issued.

DEBT = book value of long-term debt to total assets.

FSIZE = natural log of the book value of total assets.

$\varepsilon_{it}$  = the disturbance or error term.

### 6. FINDING AND DISCUSSIONS

#### 6.1. Descriptive Analysis

From Table I, the average value for Tobin's Q is 1.700 for 125 family companies. This indicates that the firm performance on family companies listed in Stock Indonesia Exchange is consider high valuation, average the companies have higher market value than the book value. Meanwhile, those companies that have high credibility in public and the management of the company have been successfully managing the company's assets also show high potential for investment growth.

The average number of board size is four people per board and board commissioner is 40%. The minimum and maximum

**Table IV. Chow test for panel data.**

Effect test	Prob.	Conclusion
Cross Section F	0.000	Fixed effect model

**Table V. Regression analysis.**

Variables		Coefficient	t-statistic	Prob.
C		1.8025	1.3350	0.1824
BSIZE	H <sub>1</sub>	0.1885	4.0326	0.0001
BCOM	H <sub>2</sub>	0.5355	0.7741	0.4392
MOWN	H <sub>3</sub>	-0.6701	-1.0593	0.2899
DEBT		0.7168	5.6866	0.0000
FSIZE		-0.1289	-1.0854	0.2782
R <sup>2</sup>		0.0765		

Notes: \*Significant at 0.1 (2 tailed); \*\*significant at 0.05 (2 tailed); \*\*\*significant at 0.01 (2 tailed); Q = market value of ordinary shares plus the book value of preferred shares and debt divided by the book value of the total assets; BSIZE = number of directors on the board; BCOM = percentage of independent board of commissioners divided by total board commissioners; MOWN = percentage of shares owned by board of directors divided by total number of shares issued; DEBT = book value of long-term debt/total assets; FSIZE = natural log of the book value of total assets.

board size is two members and twelve members. This proves that majority companies listed on the Indonesia Stock Exchange have followed the guidelines *Bapepam-LK* that the public company shall have at least three members of the board (Law No. 40 of 2007) and has at least 30% of the ranks of board commissioner was independent board commissioner. From Tables II and III, there are some Indonesian companies that still do not complying with *Bapepam-LK* guidelines, where the companies have below three directors on board and less than 30% board composition shareholders.

For managerial ownership, the minimum number of managerial ownership shows 0%. Meanwhile, there are companies with certain period of its ownership structure is not held by the management company. For example, PT. Astra Agro Lestari Tbk does not have managerial ownership for certain period. The average of managerial ownership shows is 4%. This proves that the interest of members of the council to be a shareholder or owner of the company is still low.

In terms of debt, the average debt in Indonesia is 62%. Meanwhile, the average public company in Indonesia Stock Exchange has a policy of funding the company's assets are financed by debt amounting to 62% of total assets. The average for firm size is 12.098, with maximum of 13.917 and minimum of 10.048. That shows family company in Indonesia is a large company because it exceeds the requirement of companies listed on Indonesia Stock Exchange with a value of net assets of more than 10 Billion Rupiah.

## 6.2. Panel Regression Analysis

From Table IV, Chow test results show that the value of Prob. Cross Section F (0.00) is less than  $\alpha$  (5%), so the regression model which is most appropriate is the fixed effects model. F-test is less than 0.05, meanwhile that independent variables (board size, independent of board commissioners and managerial ownership) and control variables (debt and firm size) have significant relationship with firm performance (Tobin's Q).

The result analysis in Table V shows that hypothesis H<sub>2</sub>, and H<sub>3</sub> are not supported. It is a predicted that independent board commissioners can decrease the firm performance because it did not give any contribution to firm value.<sup>18</sup> The finding is consistent with previous study.<sup>3</sup> The finding also revealed that managerial ownership has a negative relationship with firm performance. Poor financial performance might have no real foundations and could

simply lead to reduce in the value of firm shares. However, for board size on family companies, larger boards provide effective oversight of management and different view representation from stakeholders for increasing the firm performance. It is consistent with previous study<sup>11</sup> Moreover, larger boards give benefit in term of directors' expertise and networking among board of directors.<sup>12</sup>

The control variables, DEBT affect positively on family firm performance and FSIZE has a negative relationship with firm performance. The small firm size shows a higher firm performance than larger firm. The reason is that the management cannot fully monitor and control the companies when the companies become too large in size. Thus firms performance decreases.<sup>11</sup>

## 7. CONCLUSION AND LIMITATIONS

This study evidences that board size has a positive relationship with firm performance. Larger board size provides more resource and high solving problem capabilities, thus firm performance increases. The family companies using different strategy and involve a high sense of belonging towards company to achieve the company goals'. However, independent board of commissioner does not contribute to firm value. Further, manager who has a high portion managerial ownership are concern on personal interests rather than firm's interest. Therefore, future research may consider comparing the family firm performance for companies controlled by family members and professionals. Also, future study can consider unaffiliated director, board expertise, and board qualification to be examined.

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