INDEPENDENT DIRECTORS AND FIRM PERFORMANCE IN FAMILY CONTROLLED FIRMS: EVIDENCE FROM INDONESIA

Muhammad Prabowo and John Simpson

ABSTRACT

We analyse the relationship between board structure and firm performance in family-controlled firms, using a sample of Indonesian non-financial companies. We find that the share of independent directors on the board has an insignificant relationship with firm performance. We suspect that the result is driven by the lack of institutional reforms in relation to the appointment of independent directors. Our analysis shows strong empirical support for the proposition that family control (family ownership and family involvement on the board) is negatively related to firm performance. However, the significant effect of family ownership disappears when family involvement on the board is taken into the model. This result indicates that family ownership is more detrimental to firm performance whenever the family is highly involved in control decisions. Our results suggest that Indonesia needs to implement governance reforms that prevent majority owners from exercising excessive control over firms.
1. INTRODUCTION

A study by the World Bank (2005) has indicated poor implementation of institutional reform in Indonesia with adverse implications for corporate governance. Global trends in corporate governance reform have emphasised board independence. This trend is grounded in the agency framework, which claims that a more independent board tends to make better decisions (Dahya and McConnel 2005). Many countries have taken heed of the call for more independent directors, assuming that this will lead to better decisions and greater investor protection. In 2001, Indonesia required that listed firms’ boards comprise at least 30 per cent independent directors, or that the number of independent directors be proportional to the shareholding by minority investors, whichever is higher. This requirement does not regulate the board leadership structure as Indonesia has officially adopted a two-tier board system.

In most developing economies, firm ownership is concentrated in the hands of a few wealthy families (Lemmon and Lins 2003). Morck and Yeung (2003) argue that the management of family-controlled firms, acting solely for the controlling family, potentially worsens the agency problem. The main agency problem is related to the conflict between the controlling family and minority shareholders (Shleifer and Vishny 1997).

In this study of family-controlled firms, we examine the relationship between the representation of independent directors, controlling family ownership, controlling family involvement on the board of directors, and firm performance. The study contributes to the governance literature in several ways. First, we disentangle the impact of family
ownership and family involvement in boards on the performance of firms—an issue that has not been addressed in most studies of firms under family-control.

Second, we focus on Indonesia. Although the association between the board of directors and firm performance has received considerable attention, most such studies have focused on the US, which it is claimed has strong legal protection, dispersed ownership, active institutional investors, and a large, deep and active market (Erickson et al. 2005; La Porta et al. 1999). In contrast, Indonesia has been documented as having a weak legal system, ownership concentrated in the hands of a few wealthy families, and a less developed market for corporate control (Beck et al. 2003; La Porta et al. 1998). Matolcsy et al. (2004) believe that departure from the US setting has a significant impact on the firm-level governance structure, its effectiveness, and firm value. Accordingly, we examine the effectiveness of firm-level governance mechanisms in Indonesia. Third, we control for endogeneity and non-linearity issues, which are ignored in most empirical studies investigating the impact of board structure.

The remainder of the paper is organised as follows. Section 2 develops the research issues and questions. Section 3 describes research method. Section 4 discusses the empirical tests and the robustness of the results. Section 5 discusses the results, the policy implications, and the limitations of the study. Section 6 provides the conclusion.

2. BACKGROUND AND LITERATURE

Agency theory contends that use of outside directors enhances board independence and, ultimately, firm performance (Fama and Jensen 1983). Peng et al (2003) argue that the underlying assumptions of agency theory have been claimed as universally applicable and therefore the advantages and the disadvantages of independent directors are relevant
to all economies. However, the empirical literature fails to produce conclusive findings. For example, Hutchinson and Gul (2004) find a positive relationship between the proportion of independent directors and firm performance, while Lawrence and Stapledon (1999) find a negative relationship. Arguably, such a finding might be attributed to the existence of interdependence relationships among governance mechanisms (Radiker and Seth 1995). Interdependence implies that the importance of the board as a monitoring device depends on the presence of other strong monitoring devices.

A study by Agrawal and Knoeber (1996) found that board monitoring is less important in the presence of the multiplicity of control mechanisms in the US, which has a strong institutional environment. It has been argued that this setting enhances the effectiveness of both internal and external governance mechanisms in reducing the self-interested behaviour of agents (Erickson et al. 2005). By contrast, Indonesia has been characterised as having a weak institutional environment (Patrick 2001), where poor legal enforcement and the absence of a market for corporate control have been claimed as facilitating controlling owners in diverting firm resources (Krishnamurti et al. 2005). Scott (1999) argues that in such an environment, the strengthening of internal governance mechanisms will create immediate benefits, while benefits from the development of markets for corporate control can be expected to emerge in the long term. Although the theoretical basis for this view is limited, it implies that it would be beneficial to enhance board independence in order to compensate for the absence of external governance mechanisms. Accordingly, board monitoring should be very
important in Indonesia, where there is an absence of control mechanisms. Thus, we expect that independent directorship is positively related to firm performance.

Similar to other Asian countries, the ownership of Indonesian-listed firms is concentrated in the hands of a few families (Claessens et al. 2000). Shleifer and Vishny (1986) argue that the presence of large shareholders might serve as a governance mechanism as their significant ownership provides them with the incentive to monitor management and sufficient voting power to replace badly-performing managers. However, a high level of stockholding also provides large shareholders with control over the firm’s decisions, which enables them to deprive minority shareholders of their rights (La Porta et al. 2000).

Although the disadvantage of controlling shareholders might be mitigated by the presence of unrelated block holders, Maury and Pajuste (2005) and Faccio et al (2001) argue that block holders in Asian economies are more likely to collude with controlling shareholders to divert firm resources. This view suggests that the negative effect of the controlling family in Asia applies irrespective of the presence of other governance mechanisms. Therefore, we expect that ownership concentration by a controlling family is negatively related to firm performance.

It has been argued that the prevalence of family control provides a rationale for using the family, instead of individuals, as the unit of analysis, as the family members of the controlling owners share the same interests and will pursue similar behaviour in the contracting environment. Claessens et al (2002), for example, argue that using the family as the unit of analysis is useful as this approach better portrays the real control of the firm. One implication of family members sharing the same interests is that family
ownership includes shareholdings by both family members and by parties considered to be under the influence of the family (Villalonga Amit 2006). 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. Although this approach lacks theoretical support, there is a significant incidence of governance research taking this approach (for example, Ehrhardt and Nowak 2001; Mitton 2004).

An important issue related to the prevalence of ownership concentration is family involvement in the board of directors (Tabalujan 2002). Specifically, control of the firm is enhanced through the appointment of family members to serve on the board of directors. The interest-sharing argument suggests that the family members of controlling owners serving on the board represent the interest of their family. Therefore, it might be argued that the family members of controlling owners serving on the board might be sharing the same interests with management that has been claimed as acting solely for the controlling family (Morck and Yeung 2003). This line of reasoning implies that the directors among controlling family members could have identical interests to the executive directors. As the controlling family owns a substantial shareholding of the firm, the family members of controlling owners serving on the boards might raise the type of insider-ownership problem advanced by Morck et al (1988).

Jensen and Meckling (1976) argue that higher levels of ownership potentially lessen the incentive of insiders to pursue self-interested action, as their wealth is sensitive to organisational outcome. Therefore, higher insider ownership enhances the convergence of interests of insiders and outside shareholders. However, Nam (2003:2) suggests 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’. These conditions are generally not fulfilled in most Asian economies (Roche 2005).

In these circumstances, firm disciplinary mechanisms are less likely to be able to remove poorly-performing insiders, given the entrenchment effect associated with higher insider ownership. Eventually, the absence of the threat of dismissal facilitates the family members serving on the board representing the interest of the family by transferring corporate resources to themselves, thereby curtailing firm performance. Therefore, we predict that the proportion of family members of controlling owners serving on the board is negatively related to firm performance.

With regard to the derivation of the model to be tested, the following literature is noted. The model includes board size, firm’s age, and industry as control variables. Board size has been claimed as determining the effectiveness of the board’s monitoring role, with larger boards able to undertake a greater number and wider scope of monitoring duties (Yermack 1996). The firm’s age has a logical relationship with the firm’s size (Schellenger et al. 1989), whereby the influence of controlling shareholders over board member selection increases as firms grow larger (Yeh and Woidtke, 2005). The type of industry reflects the nature of business, which potentially affects corporate performance (Barnhart et al. 1994).

With regard to the expected sign of the relationship between independent directorship and firm performance, Hermalin and Weisbach (2003) argue that the negative
association might be driven by an endogenous effect of board appointment, whereby poorly-performing firms tend to appoint more independent directors to convince market participants that the company is aware of poor performance being associated with greater agency problems. Another plausible explanation is that the marginal cost of appointing additional outside directors outweighs the marginal benefit beyond a particular point (Bhagat and Black 2002).

In respect of the relationship between family shareholding and performance, Haniffa and Hudaib (2006) documented better accounting performance associated with the concentrated ownership of Malaysian-listed firms. This is not consistent with the findings in this paper, as discussed in the results section.

The issue of the type of measure of board composition has been addressed by researchers such as Rhoades et al (2000), Baysinger and Butler (1985), Block (1999), and Postma (1999). The last-mentioned addressed the linearity of the relationship.


3. RESEARCH METHOD

We use various data sources namely: company annual reports (AR), the Indonesian Capital Market Directory (ICMD), the Profile of Publicly Listed Companies (PPLC), Prominent (PRO), and Jakarta Stock Exchange (JSX) list of independent directors. The
performance indicator was obtained from the ICMD database. To identify the controlling owners, we first refer to annual reports, which disclose the immediate owners. We then trace the immediate owners to the PPLC in order to identify the firm’s business group and the ultimate owners.\(^1\) Information on the boards of directors was gathered from annual reports, which stipulate the names and numbers of directors. The names of directors were traced to the JSX publication and PRO in order to identify the independent directors and the directors among controlling family members. Table 1 provides a summary of the variables of interest and data sources.

**Table 1: Measures and Data Sources of Variables of Interest**

<table>
<thead>
<tr>
<th>Variables</th>
<th>Acronym</th>
<th>Measures</th>
<th>Sources</th>
</tr>
</thead>
<tbody>
<tr>
<td>Return on Assets</td>
<td>ROA</td>
<td>The ratio of earnings before interest, extraordinary items, and taxes to total assets as of 2003.</td>
<td>AR</td>
</tr>
<tr>
<td>Independent directors</td>
<td>IDP</td>
<td>The ratio of the number of independent directors to the total number of directors.</td>
<td>AR, JSX list</td>
</tr>
<tr>
<td>Board Size</td>
<td>BSIZE</td>
<td>Total number of directors on the board of the company.</td>
<td>AR</td>
</tr>
<tr>
<td>Controlling family ownership</td>
<td>FML</td>
<td>The ratio of shares owned by the largest shareholder to total outstanding shares.</td>
<td>AR, PRO PPLC,</td>
</tr>
<tr>
<td>Directors of Controlling family</td>
<td>FMBD</td>
<td>The ratio of the number of family members of controlling owners serving on the board to total number of directors.</td>
<td>AR, PRO PPLC,</td>
</tr>
<tr>
<td>Age</td>
<td>AGE</td>
<td>2003 minus the year of incorporation</td>
<td>AR</td>
</tr>
<tr>
<td>Industry</td>
<td>IND</td>
<td>3-digit JSX industry classification</td>
<td>ICMD</td>
</tr>
</tbody>
</table>

The sample is based on all industrial firms listed on the Jakarta Stock Exchange (JSX) as at 31 December 2003. We excluded firms that had negative equity, those that were not present in all data sources, property and financial service firms, and observations that were outliers (more than three standard deviations from the mean). This sampling procedure gave a sample of 152 firms.

\(^1\) In most cases, the ultimate owner had two names, the original Chinese name and an Indonesian name. For example, the ultimate owner of PT Indofood Sukses Makmur, Tbk is Liem Sioe Liong (Chinese name) alias Soedono Salim, (Indonesian name).
Firm performance is measured using Return on Assets (ROA), defined as the ratio of earnings before deduction of interest costs, extraordinary items, and taxes to total assets as of 2003. Consistent with the JSX, we define an independent director as an individual without any affiliation with management, other directors, controlling owners, and who does not serve as a commissioner in any other affiliated firm. The fraction of independent directors is defined as the ratio of independent directors to the total number of directors. Similarly, the fraction of the directors of the controlling family is defined as the ratio of the family members of the controlling owners on the board to the total number of directors. We aggregate the individual shareholdings of family members (by marriage and blood, both to second degree vertically and horizontally) of controlling owners to construct controlling family ownership. We define the controlling shareholders’ ownership by simply accumulating the cash-flow rights of their immediate ownership. We use a 20 per cent shareholding as a cut-off in differentiating between a dispersed firm and a family-controlled firm.

We use the following model to analyse the relationship between board structure and firm performance.

$$\text{ROA}_{it} = \alpha + \beta_1 \text{IDPDIR}_{it} + \beta_2 \text{FML}_{it} + \beta_3 \text{FMBD}_{it} + \beta_4 \text{BSIZE}_{it} + \beta_5 \text{AGE}_{it} + \beta_6 \text{IND}_{it} + \epsilon_{it}$$  \hspace{1cm} 1)

Where:

- $\text{IDPDIR}_{it}$: The fraction of independent directors of firm $i$ at year $t$
- $\text{FML}_{it}$: Controlling family ownership of firm $i$ at year $t$

4. RESULTS

4.1. Descriptive Statistics and Correlations

Table 2 presents the descriptive statistics and correlations of the variables. The fraction of independent directors in 131 firms is 33 per cent or higher. This suggests that most Indonesian-listed firms have complied with the JSX regulation that the proportion of independent directors of listed firms should be at least one-third of the total number of directors.

The average shareholding by domestic controlling owners is 58 per cent, confirming the prevalence of concentrated ownership of Indonesian firms. On average, the boards of directors are comprised of 31 per cent of controlling family members, indicating that a high degree of owners’ involvement in corporate control is a salient feature of Indonesian-listed firms.

Table 2: Descriptive Statistics and Correlations (N=152)

<table>
<thead>
<tr>
<th>Descriptive Statistics</th>
<th>Correlations</th>
</tr>
</thead>
<tbody>
<tr>
<td>Min</td>
<td>Max</td>
</tr>
</tbody>
</table>

In all cases, the immediate owner of the firm was another company of a particular business group owned by the same controlling owners. On some occasions, the firm was jointly owned by several families who formed a partnership to control the firm. However, this joint ownership is a floating rather than a permanent coalition. For example, Soedono Salim (Salim group) and Dick Gelael (Gelael group) formed a coalition to gain majority control of PT Fast Food Indonesia; while on another occasion Soedono Salim formed a partnership with Siti Hardiyanti Rukmana (Citra group, the oldest daughter of former president General Soeharto) and Jopie Widjaja (Infinity group) to control PT Citra Marga Nusaphala Persada.
The boards of Indonesian-listed firms range between two and ten directors, indicating that listed firms in Indonesia have met the regulation requiring publicly-listed corporations to appoint at least two directors. The mean age of firms is 26 years, suggesting that most firms have been incorporated since the mid-1970s.

The family members of controlling owners serving on the board (FMBD) has a positive association with controlling family ownership (FML), suggesting that family-controlled firms are more likely to have higher family involvement on boards. The fraction of family members of controlling owners serving on boards is negatively correlated with board size (BSIZE), indicating that the proportion of directors of the controlling family declines as boards grow larger. Firm age (AGE) is negatively correlated with family ownership, indicating that a higher level of ownership by a controlling family is more likely to be found in younger firms. Firm age is also positively correlated with industry classification (IND).

4.2. Multivariate Data Analysis

Table 3 reports the results from the ordinary least-squares regression of ROA on board composition and family control. In specification 1 the fraction of independent directors

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4 Company Law 1995 art 94 (2) and articles 79 (2).
5 This is consistent with Husnan (2002) who notes that during this period, the government switched its development focus from agriculture to manufacturing through providing low interest rates and taxation incentives. As a result, new industries emerge in that period.
is a significant predictor of firm performance at the 10 per cent significance level. Contrary to our prediction, the sign of the outside director variable is negative, suggesting that a higher fraction of independent directors is associated with lower firm performance. Controlling family shareholding (FML) has a negative relationship with accounting performance at the one per cent level of significance, suggesting that firm performance is better with more diffused share ownership. This finding is not consistent with the work of Haniffa and Hudaib (2006), for example, who documented a higher accounting performance in the concentrated ownership of Malaysian-listed firms. However, their research did not differentiate between controlling owners and unrelated large shareholders, which might confound their result. Board size (BSIZE) is insignificantly related to firm performance.

Specification 2 indicates that controlling family involvement on the board (FMBD) is negatively related to a firm’s performance. This relationship is significant at the one per cent level, which indicates that controlling family involvement on the board is more likely to create an entrenchment effect, rather than an alignment effect, and therefore exacerbates agency problems. The relationship between independent directors and firm performance becomes insignificant.

Specification 3 suggests that controlling family involvement on the board is negatively related to firm performance. In the presence of such involvement, the impacts of independent directors and controlling family ownership on firm performance become insignificant. This finding indicates that controlling family involvement on the board is a consistent predictor of firm performance and implies that controlling family ownership is more detrimental to firm performance whenever the controlling owners are involved
in board decisions. As controlling family ownership is positively associated with controlling family involvement on boards, this finding suggests that excessive control-enhancing mechanisms are detrimental to firm performance.

Table 3: Cross-sectional OLS Regression of ROA on Board Composition, Controlling Family Shareholding, and Controlling Family Involvement on the Board (N=152)

<table>
<thead>
<tr>
<th></th>
<th>1</th>
<th>2</th>
<th>3</th>
</tr>
</thead>
<tbody>
<tr>
<td>(Constant)</td>
<td>0.028</td>
<td>0.011</td>
<td>0.041</td>
</tr>
<tr>
<td></td>
<td>(0.459)</td>
<td>(0.200)</td>
<td>(0.675)</td>
</tr>
<tr>
<td>IDP</td>
<td>-0.096*</td>
<td>-0.076</td>
<td>-0.084</td>
</tr>
<tr>
<td></td>
<td>(-1.684)</td>
<td>(-1.358)</td>
<td>(-1.499)</td>
</tr>
<tr>
<td>FML</td>
<td>-0.001***</td>
<td>-</td>
<td>0.000</td>
</tr>
<tr>
<td></td>
<td>(-2.649)</td>
<td>-</td>
<td>(-1.288)</td>
</tr>
<tr>
<td>FMBD</td>
<td>-</td>
<td>-0.098***</td>
<td>-0.082***</td>
</tr>
<tr>
<td></td>
<td>-</td>
<td>(-3.650)</td>
<td>(-2.775)</td>
</tr>
<tr>
<td>BSIZE</td>
<td>0.004</td>
<td>0.001</td>
<td>0.002</td>
</tr>
<tr>
<td></td>
<td>(1.326)</td>
<td>(0.401)</td>
<td>(0.470)</td>
</tr>
<tr>
<td>AGE</td>
<td>0.026</td>
<td>0.031**</td>
<td>0.027**</td>
</tr>
<tr>
<td></td>
<td>(1.768)</td>
<td>(2.162)</td>
<td>(1.851)</td>
</tr>
<tr>
<td>IND</td>
<td>0.000</td>
<td>0.000</td>
<td>0.000</td>
</tr>
<tr>
<td></td>
<td>(-0.585)</td>
<td>(-0.787)</td>
<td>(-0.705)</td>
</tr>
<tr>
<td>Ajd-R2</td>
<td>0.091</td>
<td>0.127</td>
<td>0.131</td>
</tr>
<tr>
<td>F</td>
<td>4.010</td>
<td>5.379</td>
<td>4.780</td>
</tr>
</tbody>
</table>

Note: t-values are given in parentheses. ***, ** and * represent significance at the 1 per cent, 5 per cent, and 10 per cent level, respectively. Variable definitions are given in Table 1.

4.3. Sensitivity Analysis

It has been argued that the way in which board composition is measured affects testing of the association between board composition and firm performance (for example, Rhoades et al. 2000). To address this issue, the study ran an OLS regression using a different measure of independent directors’ representation, where the value of independent directors is zero if the boards consists of less than 30 per cent independent directors, one if the proportion of independent directors ranges from 30 per cent to 40 per cent, and two if the board comprises more than 40 per cent independent directors. It
is claimed that this measure better reflects differences in board representation (for example, Baysinger and Butler, 1985). The results are presented in Table 4, specification 1. The representation of independent directors remains insignificantly related to firm performance, suggesting that the insignificant association is robust to alternative measures of board composition.
Table 4: Cross-sectional OLS and 2SLS Regressions of ROA on Board Composition, Controlling Family Shareholding and Controlling Family Involvement on Boards (N=152)

<table>
<thead>
<tr>
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<tbody>
<tr>
<td>(Constant)</td>
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<td>0.036</td>
<td>0.030</td>
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<td>(0.351)</td>
<td>(0.539)</td>
<td>(0.438)</td>
<td>(1.83)</td>
<td>(0.633)</td>
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</tr>
<tr>
<td>IDP</td>
<td>-</td>
<td>-</td>
<td>-0.009</td>
<td>-0.438</td>
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</tr>
<tr>
<td></td>
<td>-</td>
<td>-</td>
<td>(-0.044)</td>
<td>(-1.018)</td>
<td>(-1.204)</td>
</tr>
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<td>IDPRANK</td>
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<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td></td>
<td>(-0.758)</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>BD30</td>
<td>-</td>
<td>-0.005</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td></td>
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<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>BD3050</td>
<td>-</td>
<td>0.102</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
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<td></td>
<td>(0.584)</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
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<td></td>
<td>(-1.367)</td>
<td>-</td>
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<td>-</td>
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<td>-</td>
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<td>-</td>
<td>-</td>
<td>(-0.386)</td>
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<td>-</td>
</tr>
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<td>FML</td>
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<td>0.000</td>
<td>0.000</td>
<td>0.000</td>
</tr>
<tr>
<td></td>
<td>(-1.144)</td>
<td>(-1.384)</td>
<td>(-1.273)</td>
<td>(0.238)</td>
<td>(-1.440)</td>
</tr>
<tr>
<td>FMBD</td>
<td><strong>-0.085</strong>***</td>
<td><strong>-0.082</strong>***</td>
<td><strong>-0.083</strong>***</td>
<td><strong>-0.318</strong>***</td>
<td><strong>-0.084</strong>***</td>
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<tr>
<td></td>
<td>(-2.862)</td>
<td>(-2.729)</td>
<td>(-2.792)</td>
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<td>-</td>
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<td>LEAD</td>
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<td>-</td>
<td>-</td>
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</tr>
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<td></td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>(0.215)</td>
</tr>
<tr>
<td>BSIZE</td>
<td>0.002</td>
<td>0.001</td>
<td>0.001</td>
<td>-0.005</td>
<td>0.002</td>
</tr>
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<td>(0.162)</td>
<td>(0.404)</td>
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<td>(0.639)</td>
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<td>AGE</td>
<td><strong>0.028</strong></td>
<td><strong>0.025</strong></td>
<td><strong>0.026</strong></td>
<td>-</td>
<td><strong>0.029</strong>***</td>
</tr>
<tr>
<td></td>
<td>(1.918)</td>
<td>(1.730)</td>
<td>(1.823)</td>
<td>-</td>
<td>(2.032)</td>
</tr>
<tr>
<td>IND</td>
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<td>0.000</td>
<td>-0.000</td>
<td>0.000</td>
</tr>
<tr>
<td></td>
<td>(-0.734)</td>
<td>(-0.570)</td>
<td>(-0.634)</td>
<td>-</td>
<td>(-0.664)</td>
</tr>
<tr>
<td>Ajd-R2</td>
<td>0.121</td>
<td>0.127</td>
<td>0.125</td>
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<td>0.139</td>
</tr>
<tr>
<td>F</td>
<td>4.451</td>
<td>3.747</td>
<td>4.094</td>
<td>5.637</td>
<td>4.059</td>
</tr>
</tbody>
</table>

Note: t-values are given in parentheses. ***, ** and * represent significance at the 1 per cent, 5 per cent, and 10 per cent levels, respectively.

In two of three specifications, the fraction of independent directors is found to have an insignificant relationship with firm performance. Block (1999) argues that this pattern might be driven by a non-linear relationship. The study follows two approaches to capture the possibility of non-linear relationships between the proportion of independent
directors and firm performance. The first uses piece-wise linear regressions, which allow for two changes in the slope coefficient on board composition using the following variables.

\[
\begin{align*}
BD30 &= \text{proportion of outside directors if the proportion of independent directors} < 30\% \\
&= 30\% \text{ if the proportion of independent directors} \geq 30\% \\
BD30-50 &= \text{proportion of independent directors minus 30\% if } 30\% \leq \text{proportion of independent directors} < 50\% \\
&= 20\% \text{ if the proportion of independent directors} \geq 50\% \\
BD50 &= \text{0 if the proportion of independent directors} < 50\% \\
&= \text{proportion of independent directors minus 50\% if the proportion of independent directors} \geq 50\%
\end{align*}
\]

Second, following Postma (1999), the study employs a quadratic representation of board composition. Table 4, specifications 2 and 3 report the OLS regressions linking board composition to firm performance using the piece-wise method and the quadratic, respectively. In all specifications, the independent directors are insignificantly related to firm performance.

The relationship between the governance mechanism and firm performance might suffer an endogeneity problem, leading to a biased result (see Börsch-Supan and Köke 2002). Following Seifert et al (2004), the study uses the 2SLS regression technique to address this issue (Table 4, specification 4). The dependent variable is ROA 2003 and the instrumental variables are the proportion of independent directors, the fraction of family directors, controlling family shareholdings, and firm performance in 2001 (lag-2).

Consistent with the results from the OLS analyses, the independent directors and board size variables are insignificantly related to firm performance in all specifications. This finding indicates that the proportion of outside directors is not endogenously determined by prior poor performance. The involvement of controlling families on boards remains significantly related to firm performance, suggesting that such involvement discourages
firm performance and not vice versa. Controlling family ownership becomes an insignificant predictor of firm performance, indicating that the association between this variable and firm performance is moderated by the presence of a control-enhancing mechanism.

A board’s advisory and control roles as reflected in board committees may be used as a proxy for the specific duties of the board. The formation of committees ‘...represents a mechanism for companies to organise their boards’ in promoting the overall effectiveness of boards (Cotter and Silvester 2003:211). Accordingly, a more rigorous approach to investigating the association between independent directors and firm performance could be by focusing on the presence of such directors in the monitoring committee (see Klein 1998). By relating a particular committee with a specific outcome, this approach could deliver a clearer test of the association between the effectiveness of independent director monitoring and organisational outcomes.

To test this proposition, Table 5, specification 5 presents the results of OLS regressions linking the representation of independent directors on audit committees. The AUD variable is the proportion of independent directors to the total number of directors serving on the audit committee. The LEAD variable is the leadership structure of the audit committee, which takes a value of zero if the independent directors serve as chairperson and one otherwise. The results show that none of the committee variables are significantly related to firm performance, suggesting that the insignificant relationship between independent directors and firm performance is robust after controlling for board committee structure.
5. DISCUSSION AND LIMITATIONS OF THE STUDY

The World Bank (2005) finds a lack of institutional reform that might prevent firms from appointing ‘truly’ independent directors. Specifically, this work finds an absence of nominating committees that would enable management, which represents the interests of the controlling family, to nominate the directors. The study also reports that the common voting method for the appointment of directors 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 the majority shareholders (World Bank 2005:7). This arrangement provides majority shareholders with the ability to control the board and facilitates them nominating individuals who are less likely to challenge the private benefits they derive from control. Accordingly, a system of appointment that properly accommodates the interests of non-controlling owners is needed in order to reduce majority control over appointments. This might be achieved through adopting a cumulative voting system and establishing a nomination committee.

Indonesian-listed firms are characterised by ownership concentration in the hands of controlling families and controlling family involvement in the boards. This study reveals that family ownership concentration is negatively related to firm performance. The involvement of a controlling family on the board is also found to have a negative relationship with firm performance. This suggests that family members share common interests and that they act collectively, which suggests that a check and balance system will not work effectively. Consequently, corporate governance that separates management decisions from control decisions should be encouraged.
Several caveats are in order. First, this study uses accounting numbers as a proxy of firm performance. It could be the case that Indonesian-listed firms inflate their earning statements. This may be partly attributable to the ownership structure. However, the study does not address this issue. Second, the study treated independent directors equally, irrespective of their nomination and appointment processes; which might create a bias in the results, since independent directors nominated by management or controlling owners could have a different impact from independent directors who are nominated by minority shareholders.

Third, the study relied on measures of the immediate ownership of the controlling family. This meant that voting rights and cash flow rights were not distinguished. Morck and Yeung (2003), for example, argue that expropriation is more pervasive in firms with divergence between voting rights and cash flow rights and firms that are a part of business groups.

6. CONCLUSION

We find that the share of independent directors on boards of family-controlled companies has an insignificant relationship with firm performance in Indonesia. The suspicion is that the result is driven by the lack of institutional reforms in relation to the appointment of independent directors. The analysis reveals strong empirical support for the proposition that family control is negatively related to firm performance. But the effect of family ownership disappears when family involvement on the board is taken into the model. This result suggests that family ownership is more detrimental to firm performance when the family is highly involved in control decisions. Our results suggest
that Indonesia should implement governance reforms that would have the effect of preventing majority owners from exercising excessive control.

REFERENCES


