Combined Leadership in a Two-tier System? A Message from Indonesia

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Abstract

We extend the family-control study by examining the effectiveness of board monitoring in the family controlled firms in Indonesian. This country offers 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 governance mechanisms affect the behaviour of contracting parties. The study presents a cross-sectional analysis of 190 non-financial companies listed in Jakarta Stock Exchange in 2002.

Indonesian firms exhibit ownership concentration in the hands of a few wealthy families and accordingly, the agency problems stem from the conflicts between controlling owners and minority shareholders. The agency problem is further exacerbated by the presence of family members of controlling owners serving on the boards. We argue that the involvement creates the absence of separation between management and control decisions that potentially negates the link between governance mechanisms and firm performance. Using the framework where the family serve as the unit of analysis, we argue that the family members of controlling owners serving as the directors have identical property with insider directors. Although Indonesia adopts a two-tier system, such a framework implies that the substance of combined leadership might occur in this country whenever the family member of controlling owners is assigned as a board chairperson. We bring this argument in investigating the association between board leadership, board composition, family control and firm performance.

We find that most Indonesian listed firms have affiliated leadership, where in some instances the family member of controlling owners serves as board chairperson. This finding provides undeniable evidence that combined leadership exists in the two-tier system. The family member of controlling owner serving as board chairperson is found to have a negative relationship with firm performance, and such a relationship is robust after controlling for interdependence, measurement, and endogeneity issues. 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 to the agency problem specific to the firm. We suspect that the result is driven by the lack of institutional reforms in relation to the appointment of independent directors.

Controlling family ownership and controlling family involvement are found to have a negative association with firm performance, suggesting that the absence of separation between management and control decisions associated with ownership concentration leads to lower firm performance. However, the negative effect of family ownership decreases when the family involvement on the board is taken into account, indicating that the entrenchment effect of family involvement on the board is higher than the family ownership per se. This finding suggests the necessity to disaggregating the family control devices. Nevertheless, such involvement provides supportive evidence that controlling owners engage in excessive control enhancing mechanisms, which facilitate them to extract private benefit of control with relatively ease.

Keyword: Corporate Governance, Family control, Board Structure, Firm Performance
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1. Introduction

The global trend of corporate governance reforms has emphasized the importance of board independence. Typically, the two-tier countries advocate a minimum standard for the inclusion of independent directors on the boards of listed companies while corporate governance reform in one-tier system also include board separated leadership in their governance prescriptions. Dahya and McConnell (2005) argue that the trend is grounded on the agency framework claiming that a more independent board tends to make better decisions. In 2001, Indonesia followed such a trend and required 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. This requirement does not regulate the board leadership structure as this country mandates the firms to adopt a two-tier board system.

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 & Mc Connell, 2003). However, in most economies the ownership of the firms is concentrated in the hand of few wealthy families that provides them with almost complete control of the firms (La Porta et al., 1999, Lemmon & Lins, 2003). Consequently, the agency problem is related to the divergence of interest between those of controlling family and minority investors. Eventually, the prevalence of ownership concentration by the family has been quoted as providing a scholarly raison d'être to use the family, instead of individuals, as the unit of analysis.

We extend the family-control study by examining the effectiveness of board monitoring in the family controlled firms. Using family as the unit of analysis, we argue that the family members of controlling owners serving as the directors have identical property with insider directors. We bring this argument in investigating the association between board structure and firm performance in Indonesia. We find a systematic and significant negative association between family control (family ownership, family involvement in the board and family members serving as board chairperson) and firm performance. However, our analyses reveal that the significant effect of family ownership decreases when the family involvement in the board is taken into the model. This result indicates that family ownership does not necessarily harm firm performance unless the family highly involves in the control decisions. The proportion of independent directors exhibits insignificant relationship with firm performance. Although the inclusion of independent directors is officially required, we suspect that the result is driven by the lack of institutional reforms in relation to the appointment of independent directors.

Our study contributes to the governance literature in several ways. First, unlike the work of (Yeh & Woidtke, 2005), we further investigate the board leadership structure and its association with firm performance. Although Indonesia adopts two-tier system, we argue that combined leadership might exist in such system. Specifically, we argue that the family member of controlling owner serving as board chairperson has identical attribute to a combined leadership in a one-tier board system and thus potentially related to the lower firm performance. To the best of our understanding, we believe that ours is the first to study this issue. Secondly, we focus on the Indonesian setting. Although, board of directors has received considerable attention from academician and regulators, most studies investigating the association between board structure and firm performance focused on the US. The institutional environment of this country is characterised by strong legal protection (La Porta et al., 1999), dispersed ownership, active institutional investors, as well as a large, deep and active market (La Porta et al., 1999). In contrast, Indonesia has been documented as having low score of investor protection provided by the legal system (Beck,Demirgüç-Kunt & Maksimovic, 2003, Durnev & Kim, 2003), less developed market and inactive market for corporate control (Asian Development Bank, 2000; Nam, 2004; Zhuang, 1999), ownership concentration in the hand of controlling family (Claessens,Djankov & Lang, 2000), group-affiliated financing pattern that leaves the lending bank with less independence to monitor management action (Patrick, 2001) and the prevalence of the controlling family in management and in the board of directors (ADB, 2002; Tabalujan, 2002). Authors such as (Klapper & Love, 2004; La Porta et al., 2000; Matolcsy, Stokes & 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 value. Accordingly, the importance and value of governance mechanisms in Indonesia is an open empirical question. Third, we control for endogenenity and non-linearity issues that are left unaddressed by most empirical works investigating board structure.

The remainder of the paper is organized as follows. Section 2 develops the hypotheses. Section 3 describes the data, sample and methods. Section 4 presents the empirical results. Section 5 conducts the robustness check and section 6 concludes and discusses the results.

2. Hypothesis

An important issue pertinent to the ownership concentration by the family is the prevalence of the family members of controlling owners serving in management and in the board of directors (ADB, 2002). Indeed, in most Asian countries, "controlling owners are typically preoccupied with conducting the managerial function themselves" (Nam, 2003, p.2). Khanthavit et al. (2002) and Nam (2004) find that controlling family members occupy a significant proportion of top management teams while Khoo (2004) and Yeh (2005) confirm the involvement in the boards of Malaysian and Taiwan listed firms respectively. The family members of controlling owners have been claimed as sharing the same interests and therefore they will pursue similar and collective behaviour in the contracting environment (Urtiaga & Tribo, 2004). Claessens, Djankov and Klapper (2003) contend that using family as the unit of analysis is more beneficial as this approach better portrays the real control of the firm. This approach has important implications on the governance research. 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". Put differently, the aggregate shareholdings of family members of the controlling owners are treated identically to the shareholding of a single person in the framework where individuals serve as the unit of analysis.

In Indonesia, where the ownership of the firm is concentrated, the controlling owners typically appoint their family members to serve in management (ADB, 2002) and in the board (Tabalujan, 2002). In such firm, the management acting solely for the controlling family and thus potentially lead to the worse agency problem (Morck & Yeung, 2003). Following the approach using family as the unit of analysis, it might be argued that the family members of controlling owners serving in the board represent the interest of their family. Therefore, the interests of the directors who are family members of controlling family are necessarily similar to those of management. Furthermore, the collective action might be achieved when the family members of controlling owners share information regarding firms' operation among them. Consequently, the family members of controlling owners serving on the board do not have an information access constrain as compared to outside directors.

Agency literature claims that the identical interests between those of the directors and management and the information access serve as the criteria in differentiating between independent and insider directors (Fama & Jensen, 1983). This line of reasoning implies that the directors of controlling family members have identical properties with insider directors. Therefore, 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 provides us with the rationale to justify that the substance of combined leadership to some extent is also prevalent empirically in a two-tier regime.

Although leadership structure has been quoted as determining the board independence and therefore firm performance (Dalton et al., 1998), empirical studies show mixed results. For example, Fosberg, and Nelson (1999) and Coles et al. (2000) find that independent leadership is associated with superior accounting earning and market return while Dehaene, De Vuyst and Ooghe (2001) and Brickley, Coles and Jarrell (1997) report the positive relationships between CEO duality and firm performance. In contrast, the works of Schmid and Zimmermann (2008) and Chen et al. (2006) reveal that leadership structure is insignificant predictor of organizational outcomes.

In Indonesia, the agency problem stems from the conflict between controlling owners and the minority shareholders (Claessens et al., 2002), where the weak legal enforcement and the absence of market for corporate control have been claimed as facilitating controlling owners 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. Although theoretical base is limited, this view implies that it would be beneficial to enhance the board independence in order to compensate the absence of external governance mechanisms. As the director who is the family member of controlling owner represent solely the interest of their family, accordingly we predict that a family member of controlling owner serving as a board chairperson is negatively related to firm performance.

The independence of management has been claimed as a prerequisite condition of board monitoring role in alleviating agency problems. As the monitoring role is best performed by independent directors, who have no affiliation with management, consequently, agency theory predicts that the board would be in a better position to exercise monitoring role whenever it comprises sufficient independent directors. This view is grounded on the premise that independent directors have the incentive to develop reputation as decision control expert where the director market for corporate control provides them with continuous opportunity and disciplinary action (Fama & Jensen, 1983). While the underlying assumptions of agency theory has been claimed as universally applied, and therefore the advantages and the disadvantages of independent directors are relevant across different populations (Vafeas & Theodorou, 1998), empirical literature fails to produce conclusive finding. The proportion of independent directors and firm performance is found to have positive relationship in Hossain, Prevost and Rao (2001) of New Zealand, the negative relationship is documented by Erickson et al.(2005) of Canadian firms, the insignificant relationship is reported by Peng, Buck and Filatotchev (2003) of Russian firms.

Radiker 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) where a firm 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 devices. For example, a study by Agrawal and Knoeber (1996) finds 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 characterized by a weak institutional environment (Patrick, 2001) and less developed market and inactive market for corporate control (Nam, 2004). Accordingly, we argue that the board monitoring is considerably important in Indonesia, and therefore we expect that independent director is positively related to firm performance.

3. Research method

Following Claessen et al. (1999, 2000), we use various data sources namely: Annual Report (AR), Indonesian Capital Market Directory (ICMD), Profile of Publicly Listed Company (PPLC), Prominent (PRO), and Jakarta Stock Exchange (JSX) list of independent directors (Table 1). Performance indicator is obtained from ICMD manual database. In order to identify the controlling owners, we first refer to the AR that discloses the immediate owners. We then trace the immediate owners to the PPLC that reports the business group of the ultimate owners[1]. Following the work of La Porta et al. (1999), we argue that this source provides the most recent reliable data. The data of board of directors is gathered from AR which stipulates the name and number of directors. The name of directors is then traced to the JSX publication and PRO in order to identify the independent directors and the directors who are controlling family members.

Table 1: Operational definition and data source of variables

Variables	Acronym	Operational Definition	Sources*
Firm performance	ROA	Earning before interests and taxes divided by total assets	ICMD
Board leadership	LEAD	Dichotomous variable equal to 1 for independent director serving as board chairperson and 2 for affiliated director and 3 for the family member of controlling owner.	AR, PPLC, PRO, JSXL
Board compositions	IDP	The proportion of independent directors to total number of directors in the board.	AR, PPLC, PRO, JSXL
Controlling family	FMLY	Common shares owned by a controlling family as a	AR, PPLC,

[1] In most cases, the ultimate owners have two names, its original Chinese and Indonesian. For example, the ultimate owner of PT Indofood Sukses Makmur, Tbk is Liem Sioe Liong (Chinese name) alias Soedono Salim, (Indonesian name) and the ultimate owner of PT Lippo Karawaci Tbk is Mochtar Riady alias Lie Mo Tie

ownership		proportion of total outstanding common shares.	PRO
Family involvement in the board	FMBD	The family members of controlling-owners serving on the board as a proportion of total number of directors	AR, PPLC, PRO, JSXL
Blockholder ownership	BLCK	Common shares owned by unrelated blockholders as a proportion of total outstanding common shares.	AR
Board size	BDSZ	Total number of directors on the board.	ICMD
Industry	IND	Nominal scale based on 2-digit JSX industry classifications	ICMD

*ICMD is the Indonesian Capital Market Directory, PPLC is the Profile of Publicly Listed Companies, PRO is the Prominent, JSXL is the list of independent directors published by the Jakarta Sock Exchange.

Our sample is based on all industrial firms that were listed in Jakarta Stock Exchange (JSX) as at 31 December 2002. We exclude banking and financial services firms as these industries have been claimed as having specific accounting standard (Lemmon & Lins, 2003). We also exclude the firms that were not presented in all data sources. This procedure leaves us with a final sample consisting of 190 firms. The final sample consists of 30 industries and mostly comprises manufacturing industries (72%). The remaining 28% are engaged in wholesale and trade, property, transportation service, communication, hotel and service, holding and investment companies, and others.

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

$$ROA_{it} = \alpha + ß_1 LEAD_{it} + ß_2 IDP_{it} + ß_3 FML_{it} + ß_4 FMBD_{it} + ß_5 BLCK_{it} + ß_6 BDSZ_{it} + ß_7 IND_{it} + \varepsilon it$$

where:

$LEAD_{it}$: leadership structure of firms i at year t

$IDP_{it::}$ the fraction of independent directors of firm i at year t

FML_{it} : controlling family ownership firm i at year t

$BLCK_{it}$: ownership by unrelated large shareholders of firm i at year t

$FMBD_{it}$: the proportion of family members of controlling owners serving in the board to total number of directors of firm i at year t

$BDSZ_{it}$: board size of firm i at year t

IND_{it}: industry group of firm i at year t

The model includes board size and industry as control variables. Board size has been quotes as having two competing effects. While Yermack (1996) argues that smaller board size facilitates the board to operate effectively, Coles, Daniel and Naveen (2008) posit that some firms need to appoint additional outside directors to ensure a quality of advice otherwise unavailable from inside directors. The type of industry might reflect the nature of business that potentially affects corporate performance (Barnhart,Marr & Rosenstein, 1994).

Firm performance is measured using Return on Assets 2002 as Joh (2003) argues that using market-based indicator is inappropriate in emerging countries where illiquid and thin trading market dictate the absence of efficient form of capital market. Return on asset is defined as the ratio of earning before interest, extraordinary item, and taxes to total asset as of 2002. We rely on the JSX list of independent directors in identifying the directors' affiliation. JSX officially defines independent directors as" individual without any affiliation with management, directors, controlling owner, and do not serve as commissioner in other affiliated firm (interlocking director)[2]. This definition is consistent with Lukviarman (2004) claiming that the concept of "directors' affiliation" in Indonesian setting should refer to the controlling owners. The board leadership is measured using dichotomous variable equal to 1 if board chairperson is held by an independent directors and 2 is held by an affiliated director and 3 is held by the family member of controlling owner. The fraction of independent directors is defined as the ratio of independent directors to total numbers of directors. Family involvement in the board is defined as the proportion of family members of controlling owners serving in the board to total number of directors

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

We use the family as the unit of analysis and therefore we aggregate the individual shareholding of family members of controlling owners to construct controlling family ownership. We follow the Capital Market Law 1995 (article 1) defining the family affiliation as a relationship by marriage and/or blood both to second degree vertically and horizontally. We define the controlling shareholders ownership by simply accumulating the cash-flow right of their immediate ownership. We use 20% shareholding as a cut-off in differentiating between dispersed firms and family-controlled firm[3]. We define blockholders as the institutional shareholders, who have no affiliation with controlling family, with at least 5% shareholding of the firm.

4. Results

4. a. Descriptive

Table 2 reports the descriptive statistics and correlations of variables of interest. The mean value of leadership structure is 2.14 indicating that most Indonesian listed firms adopt affiliated leadership. The proportion of independent director to total number of directors ranges from 0% as the minimum to 75% as the maximum. This suggests that the board of some firms comprises affiliated directors entirely, while in the other side, some firms have outsider dominated board.

Table 2: Descriptive statistics and correlations

	LEAD	IDP	FMLY	FMBD	BLCK	BDSZ	IND	ROA02
Min	1.000	0.000	0.000	0.000	0.000	2.000	1.000	-0.210
Max	3.000	0.750	99.380	1.000	49.240	10.000	24.000	0.425
Mean	2.142	0.378	57.739	0.302	2.011	4.337	17.100	0.057
SD	0.912	0.111	25.371	0.237	6.914	1.794	10.288	0.097
IDP	**-0.123 c**	1.000						
FMLY	**0.439 a**	-0.099	1.000					
FMBD	**0.596 a**	-0.035	**0.433 a**	1.000				
BLCK	-0.081	**0.193 a**	0.017	**-0.131 c**	1.000			
BDSZ	-0.081	0.016	-0.019	**-0.273 a**	-0.009	1.000		
IND	-0.011	0.007	0.095	0.022	0.007	0.002	1.000	
ROA02	**-0.231 a**	-0.077	**-0.269 a**	**-0.310 a**	-0.052	0.081	-0.079	1.000

[a], [b] and [c] represent significance at the 1%, 5%, and 10% level respectively. Variables definitions are given in Table 1.

The average proportion of independent directors is 38% indicating that most firms have lower fraction of independent directors. The fraction of independent directors of 164 firms (representing 86% of the sample) is 33% or higher suggesting that most Indonesian listed firms have complied with JSX regulation requiring the firms to appoint independent directors at least one third of total number of directors. The average board size is 4.3 ranging from 2 as the smallest to 10 directors as the largest board size. On average board of directors comprise 30% of family members of controlling owners, indicating the prevalence of controlling owners' involvement in board of directors in Indonesian listed firms. However, the proportion of family members serving as directors varies across firms, ranging from 0% as the minimum and 100% as the maximum fraction. This description indicates that family members dominate board of directors in several companies. The average shareholding by domestic controlling owners is 58% ranging from 0% to 99%[4]. Further analysis reveals that, using 20% shareholding cut-off, domestic majority shareholder is absent in 26 firms representing 14% of total sample. Of the sample, 166 firms (87%) are completely controlled by majority owners with more than 50% shareholding. The average blockholder

[3] See for example LaPorta, Lopes-de-Silanes, and Sheifler (1998) and Claessens, Djankov and Lang (2000). However, it should be noted that this cut-off point is best viewed as "researcher discretionary" as there is no theoretical work justifying this point.

[4] In all sample, the immediate owner of the firm is another company of particular business groups owned by the same controlling family. In some occasion, the firm is jointly owned by several families who form the partnership to control the firms. However, it should be noted that this joint ownership is a floating coalition, instead of permanent coalition, where the partnership changes in other firms. For example, Soedono Salim alias Liem Sioe Liong (Salim group) and Dick Gelael (Gelael group) form the coalition to control 77% of PT Fast Food Indonesia while in other occasion Soedono Salim form the partnership with Siti Hardiyanti Rukmana (Citra group, the oldest daughter of former president General Soeharto) and Jopie Widjaja (Infinity group) to control approximately 45% of PT Citra Marga Nusaphala Persada.

shareholding is 2 % ranging from 0% to 49%. However, only one third of firms exhibit the presence of unrelated blockholder. This provides supportive evidence that ownership concentration is an indisputable fact in Indonesia and only small number of firms has a dispersed ownership structure.

Overall, the correlations coefficients between independent variables are relatively low indicating that there is no multicollinearity problem. The coefficient between leadership structures (LEAD) and the proportion of outside director (IDP) is negative suggesting that affiliated leadership board has a lower number of independent directors. This suggests that the board is less likely to compensate the presence of higher number of insider directors with independent board leadership and consequently enables majority shareholders to effectively control the board. Leadership structure is positively correlated with controlling family ownership (FMLY) suggesting that affiliated leadership board is more likely to be found in the family controlled firms. Affiliated leadership firms have higher number of controlling family member serving on the board (FMBD) as the correlation shows positive coefficient significantly. This indicates the likelihood that controlling family engages in control-enhancing mechanism through dominating the board. Leadership structure is also found to have significant negative correlation with firm performance (ROA) suggesting that independent leadership is related to superior firm performance. The correlation coefficient between the proportion of independent directors and firm performance is insignificant. Family ownership is positively associated with the proportion of controlling family member serving in the board of directors (FMBD), suggesting that family controlled firms have affiliated leadership and higher family involvement in the boards. Controlling family ownership and the family involvement in the board exhibit negative correlation with firm performance suggesting that family control is associated with lower firm performance. This finding indicates supportive evidence that excessive control-enhancing mechanism is more likely to create entrenchment effect and enable controlling family to commit expropriation, which is detrimental to the minority investor wealth.

4. b. Multivariate

Table 4 presents the results of OLS regression analysis linking board composition, family control and firm performance based on ROA. Specification 1 shows that leadership structure (LEAD) demonstrates significant relationship with firm performance at 1% significance level. The negative sign suggests that better firm performance would be observed in the separated leadership firms and thus support the notion that independent leadership is more likely to mitigate agency problem (Fama and Jensen, 1983). The result is consistent with the work of Krivogorsky (2006) of EU firms listed in the US and Pi and Timme (1993) of the US commercial bank holding companies. Independent director (IDP) is an insignificant predictor of firm performance. However, the negative sign is in contrast with the prediction suggesting that higher fraction of independent director is associated with lower firm performance. According to Hermalin and Weisbach (2003) the negative association might be driven by endogenous effect of board appointment. Particularly, poor performing firm tend to appoint more independent director to convince market participant the company is aware of poor performance associated with higher agency problem. Board size (BDSZ) is insignificantly related to firm performance. Although insignificant, the relationship is positive suggesting that larger board size is beneficial and thus supports the view of Coles, Daniel and Naveen (2008) claiming that larger board size is related to better firm performance whenever the board is expected to emphasize on the advisory role.

Specification 2 reveals that controlling family ownership (FMLY) is negatively related to accounting performance at 1 % significance level. This finding is consistent with Haniffa and Hudaib (2006) claiming that better market performance is more likely to be observed in the diffused firms of their Malaysian study. The lower performance of family controlled firms indicates that higher shareholding increase the likelihood of entrenched controlling family and therefore provide supportive evidence of expropriation hypothesis advanced by Claessens, et al. (2002). In the presence of controlling family ownership, the significance association between leadership structures and firm performance persists at 10% significance level while independent director variables demonstrate insignificant relationship with firm performance. Specification 3 shows that the family member of controlling owners serving on the board is a negative predictor of firm performance at 5% significance level, suggesting that higher controlling family involvement in the board is associated with lower firm performance. This indicates that controlling family involvement in the board is more likely to exacerbate agency problem. Using the family as the unit of analysis, the shareholding by family members serving as directors might be treated identical to the aggregate shareholding of their family. This implies that the presence of controlling family members on the board necessarily creates insider ownership. According to Morck et al. (1988), the entrenchment problem associated with insider ownership dominates the alignment incentive effect whenever such ownership reaches the level beyond 30%. Given that controlling family ownership of Indonesian listed firm is higher than those of suggested by Morck (1988), thus family involvement in the board appears to produce the negative effect of entrenched directors.

Table 4: Cross-sectional OLS Regression of ROA on Board Compositions, Controlling Family Shareholding, Controlling Family Involvement on the Board and Blockholders Ownership (N=190)

	1	2	3	4
(Constant)	**0.144** [a]	**0.169** [a]	**0.151** [a]	**0.168** [a]
	(3.840)	**(4.417)**	**(4.086)**	**(4.455)**
LEAD	**-0.026** [a]	**-0.016** [c]	-0.009	-0.005
	(-3.389)	(-1.949)	(-1.007)	(-0.535)
IDP	-0.085	-0.096	-0.071	-0.082
	(-1.339)	(-1.525)	(-1.142)	(-1.313)
FMLY		**-0.001** [a]		**-0.001** [c]
		(-2.610)		**(-1.925)**
FMBD			**-0.110** [a]	**-0.090** [b]
			(-2.946)	**(-2.353)**
BLCK	-0.001	0.000	-0.001	-0.001
	(-0.712)	(-0.539)	(-1.086)	(-0.885)
BDSZ	0.003	0.004	0.000	0.001
	(0.887)	(0.952)	(0.027)	(0.214)
IND	-0.001	-0.001	-0.001	-0.001
	(-1.142)	(-0.862)	(-1.054)	(-0.853)
Adj-R2	0.053	0.082	0.091	0.104
F	3.106	3.806	4.144	4.134

T-values are given in parentheses, [a], [b] and [c] represent significance at the 1%, 5%, and 10% level respectively. Variables definitions are given in Table 1.

Specification 4 reveals that family involvement on the board demonstrates a significant relationship with firm performance at 5% significance level. The relationship between leadership structures on firm performance becomes insignificant while the proportion of independent directors remains an insignificant predictor of organizational outcome. Family ownership is negatively related to firm performance at 10% significance level. However, as compared to specification 2, the significance relationship between family ownership and firm performance decreases with the inclusion of family involvement on the board. Furthermore, the presence of family members serving on the board eliminates the significance relationship between leadership structure and firm performance. This result suggests that family involvement on the board creates higher entrenchment effect than family ownership per se.

5. Sensitivity checks

5. a. Endogeneity

An important issue pertinent to the association between board composition and firm performance is the interdependence among governance mechanisms (Agrawal & Knoeber, 1996). According to Berglöf (1997), interdependence refers to the substitutability and complementary relationships among governance mechanisms[5]. The interdependence suggest that the existence and the importance of a particular monitoring device depends on and contingent to the presence of multiplicity of control mechanisms (Rediker & Seth, 1995). In other word, the existence of a particular governance mechanism might be endogenously determined by the presence of other governance mechanisms. This implies that if governance variable is endogenously determined, the OLS estimation will produce biased results (Seifert,Gonenc & Wrighta, 2004). According to Seifert et al. (2004) and Borch-Supan and Koke (2000), the two steps least squares (2SLS) technique will result in better estimates of the relationship between governance variable and performance. Following this argument, Table 5 reports the results of 2SLS

[5] 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).

linking the board compositions and firm performance. The dependent variable is ROA 2002 and the instrumental variables are the changes of fraction of family directors, family shareholdings, blockholder ownership and firm performance between 2000 and 2002. We exclude 28 firms for data availability reason leaving us with a sample consisting of 162 firms.

Table 5: Cross-sectional 2SLS Regression of ROA on Board Compositions, Controlling Family Shareholding, Controlling Family Involvement on the Board and Blockholders Ownership

		1	2	3	4
(Constant)	Beta	**0.142[a]**	**0.184[a]**	**0.143[a]**	**0.173[a]**
	t-value	**(4.304)**	**(4.80)**	**(4.454)**	**(4.54)**
LEAD	Beta	**-0.026[a]**	-0.014	-0.011	-0.002
	t-value	**(-3.152)**	(-1.357)	(-1.069)	(-0.172)
IDP	Beta	-0.087	-0.086	-0.068	-0.075
	t-value	(-1.314)	(-1.339)	(-1.062)	(-1.178)
FMLY	Beta		**-0.001[c]**		-0.001
	t-value		**(-1.926)**		(-1.594)
FMBD	Beta			**-0.113[b]**	**-0.094[b]**
	t-value			**(-2.505)**	**(-2.099)**
BLCK	Beta	0.001	-0.001	0.000	-0.001
	t-value	(1.053)	(-0.466)	(-0.341)	(-0.696)
Adj-R2		0.061	0.075	0.087	0.095
F		4.953	4.717	5.353	4.859

The dependent variable is ROA. The instrumental variables are the changes of fraction of family directors, family management, family shareholdings, foreign ownership, domestic independent large shareholders and firm performance between 2000 and 2002. T-values are given in parentheses. [a], [b] and [c] represent significance at the 1%, 5%, and 10% level respectively. Variables definitions are given in Table 1.

Leadership structures demonstrate significant relationship with firm performance at 1% significance level (specification 1). The negative sign suggest that independent leadership is associated with better firm performance. The result is consistent with those of OLS analyses, indicating that leadership structure affects firm performance and not vice versa. Put differently, the result confirms that an independent leadership is more likely to mitigate agency problem and is less likely to be a response of specific agency problem. Consistent with the result of OLS analyses, family control and family involvement on the board remain significantly related to firm performance, indicating that the previous findings are robust after control for endogeneity problem and suggest that family control is detrimental to firm performance. Independent director insignificantly affects firm performance, suggesting that the proportion of outside directors is neither driven by prior poor performance nor a significant predictor of firm performance.

5. b. Measurements

As suggested by Dalton, et al. (1998), the relationship between board composition and firm performance is sensitive to the measurements issues. Accordingly, we rerun the OLS analyses using alternative measures of independent variables (Table 6 specification 1 and 2). Based on the work of Lukviarman (2004), we decompose leadership structure into two categories, where 0 represents non-family member of controlling owners and 1 family member of controlling owners serving as board chairperson. Following Baysinger and Butler (1985), we divide the proportion into three ranks using ordinal scale based on the above and below average. The value of independent directors is 0 if the board consists of less than 30% independent directors, 1 if the proportion of independent directors is ranging from 30% to 40%, and 2 if the board comprises more than 40% independent directors. Table 6 specification 1 shows that, using different measures, leadership structure consistently exhibits significant association with the firm performance while the relationship between board composition and firm performance remain unchanged. This result suggests that such relationships are robust with alternative measure of leadership structure and the representation of independent directors. Table 6 specification 2 reveals that family ownership and family involvement on the board are significant predictors of firm performance where the significance relationship between leadership structure and firm performance disappears with the inclusion of these variables into the model.

5. c. Non-Linearity

Block (1999) suggests that the insignificant relationship between the proportion of independent directors and firm performance might be driven by the existence of a non-linearity problem. To address this issue, we adopt two techniques. The first, following Postma (1999), we employ quadratic term of board compositions. The second, we follow Morck, Sheifler & Vishny (1988) in adopting piecewise linear regression, which allows for two changes in the slope coefficient on board compositions[6] in order to capture non-linear relationship between the fraction of independent directors and firm performance. Specifically, we use the following variables to estimate and report piecewise linear regressions:

BD30	= proportion of outside directors if proportion of independent directors <30%
	= 30% if the proportion of independent directors ≥ 30%
BD30-50	= 0 if proportion of independent directors <30%
	= proportion of independent directors minus 30% if 30% ≤ proportion of independent director <50%
	= 20% if proportion of independent directors ≥ 50%
BD50	= 0 if proportion of independent directors <50%
	= proportion of independent directors minus 50% if proportion of independent director ≥ 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). However, it should be noted that the theoretical justification for these particular points is unavailable. Consequently, it is best viewed as researchers' discretionary. The results are presented in Table 6 specifications 3 (quadratic term approach) and 4 (piece-wise method). Overall, the results do not change significantly as compared to the previous analysis. The independent director remains insignificantly related to firm performance. Consistent with the work of Postma (1998), this result provides empirical support that the insignificant relationship between outsider director representations and firm performance is not driven by non-linearity association.

6. Conclusions and discussions

We investigate the association between board structure and firm performance in the family-controlled firms using a dataset of Indonesian listed firms. We find that leadership structure is significantly related to firm performance. The negative direction suggests that better firm performance would be more likely to be observed with independent leadership. The finding provides supportive evidence that a particular governance mechanism might work well in Indonesia. Particularly, independent leadership enhances the separation of management decisions from control decisions that improves the board independence that provides the board with a better position to monitor management (Fama and Jensen, 1983).

Jensen (1983) argues that chairperson possesses the authority to organize board activity and hence has the greatest influence over the board. The influence of board chairperson could be greater in the Indonesian setting due to 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) implying that Indonesian collectivism culture emphasizes on the role of the entity's leader. The members of entity are expected to demonstrate a loyalty by supporting the leader decision without questioning such decision. Consequently, board monitoring role would be enhanced more with the independent leadership in Indonesia. Governance reform, therefore, should address the board leadership structure that promotes board independence and, accordingly, board monitoring effectiveness.

Table 6: Cross-sectional OLS Regression of ROA on Board Compositions, Controlling Family Shareholding, Controlling Family Involvement on the Board and Blockholders Ownership

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[6] Morck, Sheifler & Vishny (1988) also use this technique in order to capture the non-linear relationship between insider ownership and firm performance

	1	2	3	4
(Constant)	**0.175**[a]	**0.169**[a]	**0.162** [a]	**0.160**[a]
	(4.001)	**(3.960)**	**(4.404)**	**(3.102)**
LEAD	**-0.048**[a]	-0.010	-0.012	-0.014
	(-3.240)	(-0.574)	(-0.699)	(-0.778)
IDP	**-0.106**[c]			
	(-1.667)			
IDPR		-0.012		
		(-1.180)		
BD30				-0.002
				(-0.111)
BD3050				-0.019
				(-0.099)
D50				-0.022
				(-0.890)
IDPQ			-0.117	
			(-1.532)	
FMLY		**-0.001**[c]	**-0.001** [c]	**-0.001**[c]
		(-1.809)	**(-1.905)**	**(-1.863)**
FMBD		**-0.090**[b]	**-0.087** [b]	**-0.087**[b]
		(-2.520)	**(-2.429)**	**(-2.395)**
BLCK	0.001	0.000	0.000	0.000
	(0.544)	(-0.012)	(-0.004)	(0.020)
BDSZ	0.003	0.001	0.001	0.000
	(0.775)	(0.209)	(0.172)	(-0.015)
IND	-0.001	-0.001	-0.001	0.000
	(-1.181)	(-0.963)	(-0.794)	(-0.685)
Adj-R2	0.048	0.096	0.101	0.099
F	2.890	3.872	4.028	3.301

LEAD is a dichotomous variable equal to one for board chairperson being held by non-family member of controlling owner and two being held by the family member of controlling owners. BD30 is the proportion of outside directors if the proportion of independent directors <30% and 30% if the proportion of independent directors ≥ 30%. BD3050 takes 0 if proportion of independent directors <30, = proportion of independent directors minus 30% if 30% ≤ proportion of independent directors <50% and 20% if proportion of independent directors ≥ 50%. BD50 takes 0 if proportion of independent directors <50% and = the proportion of independent directors minus 50% if proportion of independent directors ≥ 50%. IDPR takes 0 if the boards consists of less than 30% independent directors, 1 if the proportion of independent directors is ranging from 30% to 40%, and 2 if the board comprises more than 40% independent directors. IDPQ is the quadratic term of the proportion of independent directors. T-values are given in parentheses, [a], [b] and [c] represent significance at the 1%, 5%, and 10% level respectively. Operational definitions of other variables are given in Table 1.

We find that the representation of independent director is insignificantly related to the firm performance although such representation is officially mandated. One possible explanation is the lack of institutional reform, which might prevent the firm to appoint the ‘truly’ independent directors. The World Bank (2005) finds the absence of nominating committee that enables controlling family to nominate the directors and therefore provides them with the condition to control the board. Further, the same study also indicates that the common method of voting procedure for the directors’ appointment follows the slate system. This procedure facilitates controlling family to establish the board in favour of their interest and leaving minority shareholders with “no alternative other than to approve the whole package (Worldbank, 2005, p.7). Given that the independent director is expected to monitor management, which is arguably represents the interest of controlling family, such appointment potentially reduce the director’s independence in performing their role. According to Palepu, Khanna and Kogan (2002), there exists a gap between *de jure* and *de facto* convergence[7], where the de jure convergence do not necessarily lead to actual convergence in practice. This implies that the adoption of de jure OECD principles in the board reform in Indonesia potentially does not adopt the de facto spirit of the principles. Accordingly, a 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.

Controlling family ownership and the family involvement on the board are found to have negative relationship with firm performance. However, such an ownership and involvement appears to produce different impacts on the association between other governance variables and organizational outcome. These results allow us to present some interesting findings. *First*, the family involvement in the board has a higher explanatory power of firm performance than family ownership. Note that such involvement and family ownership is significantly correlated suggesting that controlling owners are more likely to appoint their family member to serve in the board. Taken together, such an involvement could be seen as a device of controlling shareholders in enhancing their control of the firms. Apparently, the negative impact on firm performance suggests that such an involvement lessens the contestability of family control where a lower contestability is predicted as being detrimental to firm performance (Maury & Pajuste, 2005). Thus, although it potentially mitigate the contracts enforcement problem, the involvement is best viewed as a control-enhancing mechanism of controlling owner in order to secure their private benefit that is not shared to minority investors. *Second*, the involvement is also found to negate the link between leadership structure and firm performance. This indicates that such involvement is a more effective device in preventing the internal mechanism to work. We argue that the involvement enables the directors of controlling family to influence control decisions in favour of the controlling family and thereby insulate management from disciplinary action in pursuing the action that is consistent with the private benefit of controlling owner. Put differently, such an involvement creates higher entrenchment effect than family ownerships per se. This suggests that the presence of family control does not necessarily negate the link between corporate governance and firm performance unless they highly involve in control decisions. Indeed, Nam (2003) argues that the presence of large shareholders might be beneficial whenever the ownership is properly separated from control of the firm. Accordingly, this finding implies that Indonesia needs to establish the corporate system that prevents the dominant owners from engaging in excessive control-enhancing mechanisms.

Several caveats are in order. First, this study uses accounting numbers as a proxy of firm performance. Fan and Wong (2002) and Bhattacharya, Daouk and Welkerp (2003) find that Indonesian listed firms inflate their earning statement generously that is partly attributable to the ownership structure. However, this study leaves this issue unattended that might lead to the failure to capture the true firm performance as a consequence of the presence of higher earnings restatement. Second, this study treated the independent directors equally, irrespective to their nomination and appointment process. This procedure might create bias in the result, since independent directors nominated by management or controlling owners could have different effect as compared to the independent directors that are nominated by minority shareholders (Vance, 1983).. Third, this study relies on the immediate ownership of controlling family that leads to the absence of disentangling between voting rights and cash flow rights. Morck and Yeung (2003) argue that the expropriation is more pervasive in firms with the divergence between voting rights and cash flow rights and firms that are a part of business groups. Therefore, relying on the immediate ownership might understate the incentive of controlling owner in depriving minority shareholders from their rights.

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[7] Gilson (2001) suggest 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.

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