THE IMPACT OF BOARD STRUCTURE AND OWNERSHIP STRUCTURE ON FIRM PERFORMANCE: AN EVIDENCE FROM BLUE CHIP FIRMS LISTED IN INDONESIAN STOCK EXCHANGE

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THE IMPACT OF BOARD STRUCTURE AND OWNERSHIP STRUCTURE ON FIRM PERFORMANCE: AN EVIDENCE FROM BLUE CHIP FIRMS LISTED IN INDONESIAN STOCK EXCHANGE

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Abstract

This study attempts to investigate the impact of board structure and ownership structure on firm performance of blue chip firms listed in Indonesia Stock Exchange. Blue chip firms is referred as LQ45 in Indonesian Stock Exchange, and it consists of 45 the most liquid firms among other firm listed in Indonesian Stock Exchange. Using balanced panel of 45 blue chip firms which spans from 2010 to 2014; this study employs a logistic regression. The findings reveal that apart from independent commissioner and audit committee, all variables have a significant impact on firm performance.

Keywords: Board Structure, Ownership Structure, Firm Performance, Blue Chip Firms, Indonesia

JEL Classification: G32, G34

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1 Introduction

The impact of board structure and ownership structure on firm performance has been extensively studied in recent years and, most studies have focused on developed markets (McConnell and Servaes, 1990; Hermalin and Weisbach, 1991; Daily and Dalton, 1994; Mehran, 1995; Yermack, 1996; Shleifer and Vishny, 1997; Xu and Wang, 1997; Barnhart and Rosenstein, 1998; Bhagat and Black, 1999; Denis and Sarin, 1999; Welch, 2003; Demsetz and Villalonga, 2001; Callen, Klein and Tinkelman, 2003; Singh and Davidson III, 2003; Drobetz, 2004; Garg, 2007; Kapopoulos and Lazaretou, 2007; Fauzi and Locke, 2012). In the past few decades, firm's owner also acts as firm's manager, and this single role has led to ineffectiveness and inefficiency in sustaining the firm's future, hence Berle and Means (1932) stated that separation between ownership and management is needed to ensure effectiveness. However, separation between ownership (principal) and management (agents) also has side effects that are inevitably caused by the arising of conflict of interest. This conflict of interest is referred as agency problem which proposed by Jensen and Meckling (1976). Therefore, in minimising the agency problem, a set of mechanisms, processes and relations by which firms are controlled and directed are required, and this is referred as corporate governance.

Corporate governance became prevalent in Indonesia since the 1997 Asian financial crisis due to the fact that most firms are exposed to the shocks wave of financial crisis. Indonesian government through the capital market regulatory body has started to initiate multiple reforms by starting enacted corporate governance's laws and regulations. Along the way, the government has developed standards and has strengthened enforcement for all listed firms in Indonesian Stock Exchange as outlined in the good corporate governance guidelines. All listed firms in Indonesian Stock Exchange should comply to corporate governance regulations. Currently, there are 15 indices in Indonesian Stock Exchange, and each indices represents its own characteristics according specification set that distinguish it from one to another indices.

An index indicating a group of firms which have high financial liquidity is referred as LQ45, and LQ45 is an abbreviation of liquidity 45 firms (blue chips indices). Blue chips indices is associated with blue chips firms which are referred as nationally recognised, well-established and financially sound firm. Blue chips firms generally sell high-quality and widely accepted products or services. Blue chip firms are known to weather downturns and operate profitably in the face of adverse economic conditions, which help to contribute to their long record of stable and reliable growth. Hence, this study attempts to explore whether high liquid and financially sound firms comply to the corporate governance regulations set and, to investigate the impact of board structure and ownership structure on firm performance.

2 Literature review

There has been growing interest recently in analysing the impact of board structure and ownership structure on firm performance. Board structure is intended to oversee the activities of a firm and, plays an important role in maintaining effective firm's management. In managing firms, management and firm's owners are at times not always in the same direction. The separation of ownership and control in some cases may lead to agency problem that arises when the two parties have different interests and asymmetric information (Jensen and Meckling, 1976). The purpose of firm's owner is to maximise his/her personal wealth, however, the purpose of agents is sometimes not align with the owners. In some cases, agents put high efforts to increase the value of the firm, but in some cases, agents also attempt to fill their personal needs. The firm's owner cannot directly ensure that the agents does not always act in the owner's best interest particularly when activities that are useful to the principal only are costly to the agent, and where elements of what the agent does are costly for the agent to observe. Indeed, the firm's owner may have high concern at the possibility of being exploited by the agent that he/she chooses not to enter into a transaction at all, when that deal would have actually been in both parties' best interests.

Several studies have examined the relationship between board structure, ownership structure and firm performance across countries with different characteristics. Most studies are conducted in developed markets, US, UK and Japan. Previous studies generated mixed results depending on the nature of the prevailing governance system for each countries. Callen, Klein and Tinkelman (2003), Kiel and Nicholson (2003), Sheridan and Milgate (2005), Adams and Mehran (2012), Fauzi and Locke (2012), and Shukeri, Shin and Shaari (2012) find that board composition is positively correlated with firm financial performance since the large boards increases the percentage of independent directors which may ensure better performance. In contrast, Yermack (1996), Barnhart and Rosenstein (1998), Liang and Li (1999), Mak and Kusnadi (2005), Garg (2007), and Cheng (2008) find that board composition is inversely related to the firm value because benefits of monitoring larger boards are outweighed by problems associated with increased asymmetric information, and morevoer, larger boards are likely to have higher coordination costs, which reduces effective monitoring. Moreover, larger boards may pose management barrier by increasing cost of monitoring due to extensive coordination and low flexibility. While, Hermalin and Weisbach (1991), Bhagat and Black (2002) and Chen, Cheung, Stouraitis and Wong (2005) find no significant relationship between board structure and performance. In conclusion, larger boards tend to increase board diversity in terms of experience, skills, gender and nationality. Yet, small boards are likely to cause lack of experienced people sit on the board.

The board composition of directors can be influenced by large shareholders because large shareholders in firms with concentrated ownership are individually motivated and have a strong incentive in monitoring management due to their significant economic stakes (Shleifer and Vishny, 1986). Firms utilising larger boards aims to have more diversified of expertise in terms of knowledge and skills. Higher external links (Dalton, Daily and Johnson, 1999), higher efficiency in decision making process (Lehn, Patro and Zhao, 2009), higher monitoring and diverse resources (Hillman and Dalziel, 2003) are benefits of having larger boards, nevertheless, larger boards may cause higher asymmetric information (Yermack, 1996). However, having small boards may bring advantages in terms of communication, monitoring and decision making process. Communication and interaction is much easier in small boards therefore it will ensure an effective and efficient tasks. Further, Lipton and Lorch (1992) suggested that having seven or eight directors on board is sufficient because large boards are less effective and it may difficult to control (Lipton and Lorch, 1992). Further, there are some other disadvantages in having larger boards; (1) it lacks of harmony, (2) it is time consuming in decision making process (Lipton and Lorch, 1992).

Yermack (1996) investigates a relationship between large board size and firm performance using 452 US industrial firms as sample for the period of 1984-1991 and, finds a negative relationship. In contrast, Mak and Li (2001) study 147 firms for the period of 1995 to investigate the relationship between board size and firm performance and, the result reveals a positive relationship. Dalton and Dalton (2005) perform a Meta analysis based on 131 studies and, find a positive correlation between large boards and firm performance.

Furthermore, if management of the company also owns subtantial shares, therefore the need to utilise the board of directors to monitor the managers in resolving the alignment problem can be lowered. There are two forms of ownership distribution; first, dispersed ownership, and second, concentrated ownership. Ownership of large companies in rich economies is typically concentrated (La Porta, López-de- Silanes, Shleifer and Vishny, 1999). Despite the fact that some companies in the United States are controlled by large shareholders, for example, Microsoft and Ford, those firms are relatively few and have drawn less attention in the corporate governance debate (Anderson and Reeb, 2003). The percentage of ownership structure in each countries is determined by the development of the stock market and the nature of state intervention and the regulation (La Porta et al., 1998). Concentrated ownership may raise board entrechment problem as a result of the interests of controlling and minority shareholders are not aligned (Morck, Shleifer and Vishny, 1988; Stulz, 1988; Morck, Wolfenzon and Yeung, 2003), and it is more prevalent in developing countries with a weak legal protection compared to developed countries with a well established of corporate governance infrastructure. On the other hand, not only has concentrated ownership generated benefit by better monitoring, it has also generated benefit by lowering the expropriation costs of large shareholders since the controlling shareholders are often actively involved in the firm management and sit on the board of directors (Hu and Izumida, 2008). Further, managers having share between 0 to 5% will make decisions that are in the interest of management and firm's owners. Nevertheless, beyond 25% of share, managers tend to act on their perquisite and it leads to board entrenchment (Morck et al., 1988).

The relationship between ownership structure and firm performance has been investigated by many researchers. Claessens and Djankov (1999), Short and Keasey (1999), Mak and Kusnadi (2005), Krivogorsky (2006), Kapopoulos and Lazaretou (2007) and Cho and Kim (2007) find that ownership structure has a positive impact on firm performance. In contrast, Xu and Wang (1999), Welch (2003), Villalonga and Amit (2006), Abor and Biekpe (2007), Lefort and Urzúa (2008) and Belkhir (2009) find that ownership structure is negatively related to firm performance since excessive managerial ownership may allow managerial consumption of perquisites and reduce probability of bidding by outside agents, thus reducing the firm value. While Cho (1998), Demsetz and Villalonga (2001), Dalton et al. (2003) and Nuryanah and Islam (2011) find no conclusion on the relationship between ownership structure and firm performance.

In summary, previous empirical research on board size suggests that greater board size in most cases is negatively associated with firm performance. In Indonesia, most firms are owned by group or family group, hence most of directors sit on board are solely appointed in accord with family's ties/kinship/collegue bonding. Therefore, it is assumed that as far as the appointment is based on kinship and not performance, therefore the number of boards will only add burden to the firm. Similar to board size, hence most firms are owned by family, therefore it is assumed that additional of managerial ownership will only hamper firm performance. Therefore, in accord to the previous studies and Indonesian context, series of testable hypothesis are derived as follow:

H_{1a} : *managerial ownership is negatively associated with firm performance.*

H_{2a} : *blockholder ownership is positively associated with firm performance.*

H_{3a} : *independent commissioner is positively associated with firm performance.*

H_{4a} : *audit committee is negatively associated with firm performance.*

H_{5a} : *board of directors is negatively associated with firm performance.*

3 Methodology

3.1 Data

Data employed in this study are obtained from the Indonesian Stock Exchange database. The sampling period is 2010 to 2014, which is five years due to the data availability and other accounting data information only 34 out of 45 firms are used in this study. Table 1 and Table 2 provide descriptive statistics and correlation matrix. The mean value of firm performance is 0.4158 with a range from 0.0000 to 1.0000, suggesting that the majority of firms have quite high performance. The mean value for managerial ownership is 0,67%, suggesting that the managerial ownership in Indonesia is quite low as other studies classify the managerial ownership at 5% to 20% as moderate, while below 5% is classified as low and above 20% as high managerial ownership. The mean value for blockholder ownership is 63,08%, suggesting that the blockholder ownership in Indonesia is moderate. The moderate proportion of blockholder ownership in Indonesian listed firms is beneficial to the firm as it can overcome the agency problem and increase firm performance. The mean value for independent commissioner is 43,48% with a range from 22,22% to 80%, suggesting that most firms have complied to the corporate governance regulation set that listed firms should at least 33% independent commissioner sit on boards. Further, when it compared to the average board size of seven, the number of independent commissioner appears to be adequate. The mean value of audit committee is 3,7 with a range from 2 to 8 persons, suggesting that most firms have moderately high audit committee members. The mean value of board of directors is 7 with a range from 3 to 12 persons, suggesting that most Indonesian listed firms have sufficient directors, and this is also consistent with previous studies (Lipton and Lorch, 1992) that board size should be limited to 7 or 8.

Table 2 presents the Pearson Correlation matrix across the variables. The correlation matrix indicates that there is no threat of multicollinearity since the correlation coeffcient does not exceed 0.50 for any of variables.

3.2 Variables

Firm performance is dependent variable, and return on asset is employed for firm performance. Managerial ownership, blockholders ownership, independent commissioners, audit committee and board of directors are used as dependent variables.

Table 1. Descriptive statistics

Variables	*Obs.*	*Mean*	*Std. Dev.*	*Min*	*Max*
Firm Performance	190	0,4158	0,4941	0,0000	1,0000
Managerial Ownership	190	0,0067	0,0273	0,0000	0,1597
Blockholders Ownership	190	0,6308	0,1897	0,0516	1,0000
Independent Commissioner	190	0,4348	0,1213	0,2222	0,8000
Audit Committee	190	3,6790	1,0872	2,0000	8,0000
Board of Directors	190	7,0052	2,1343	3,0000	12,0000

Table 2. Correlation matrix

Correlation t-Statistic Probability	X1	X2	X3	X4	X5
X1	1.000000				

X2	-0.147823	1.000000			
	-2.049362	-----			
	0.0418	-----			
X3	-0.092932	0.162816	1.000000		
	-1.279759	2.262615	-----		
	0.2022	0.0248	-----		
X4	-0.143709	0.266661	0.119087	1.000000	
	-1.991112	3.793630	1.644545	-----	
	0.0479	0.0002	0.1017	-----	
X5	0.002337	0.406223	0.387616	0.413420	1.000000
	0.032044	6.095439	5.765462	6.225449	-----
	0.9745	0.0000	0.0000	0.0000	-----

Table 3. Description of variables

Variables	Acronym	Description
Dependent Variable Firm Performance – Return on Assets	Y	The ratio of net income divided by total assets
Explanatory variables: Managerial Ownership	X_1	Percentage of ownership owned by mangerial
Blockholder Ownership	X_2	Percentage of ownership owned by blockholders
Independent Commissioner	X_3	The ratio of total independent commissioners divided by total commissioners.
Audit Committee	X_4	The total number of audit committee
Board of Directors	X_5	The total number of board directors

3.3 Model analysis

A Tobit regression is used to measure the impact of board structure and ownership structure on firm performance. The model supposes that there is a latent (i.e. unobservable) variable y_i^*. This variable linearly depends on x_i via a parameter (vector) β which determines the relationship between the independent variable (or vector) x_i and the latent variable y_i^* (just as in a linear model). There is a normally distributed error term u_i to capture random influences on this relationship. The structural equation in the Tobit model is:

$$y_i^* = \beta x_i + u_i, u_i \sim N(0, \sigma^2)$$

$$y_i = \begin{cases} y_i^* & \text{if } y_i^* > 0 \\ 0 & \text{if } y_i^* \leq 0 \end{cases}$$

The observable variable y_i is defined to be equal to the latent variable whenever the latent variable is above zero and zero otherwise

4 Findings and discussions

Table 4 provides the Tobit Regression results. The managerial ownership coefficient exhibits a significant and negative relationship with firm performance, suggesting that the higher the managerial ownership, the lower the firm performance. This negative association is evidence of entrenchment hypothesis. The result is consistent with Xu and Wang (1999), Welch (2003), Villalonga and Amit (2006), Abor and Biekpe (2007), Lefort and Urzúa (2008), Belkhir (2009). The result provides no support to the agency model theory that higher managerial ownership should reduce agency costs and hence increases firm performance, and therefore it can be regarded as one of the effective mechanisms for mitigating agency problems in Indonesian firms. Furthermore, higher managerial ownership at some point may be detrimental to Indonesian firms' performance.

The coefficient for blockholder is a positive and significant, suggesting that the higher the blockholder ownership, the higher the firm performance. This indicates that the larger blockholder ownership, the less conflict between majority shareholder and minority shareholders as confirmed in the principal-principal agency theory. This result is consistent with Claessens and Djankov (1999), Short and Keasey (1999), Mak and Kusnadi (2005), Krivogorsky (2006), Kapopoulos and Lazaretou (2007) and Cho and Kim (2007).

The coefficient for independent commissioner is a positive and not significant, suggesting that there is no impact of the independent commissioners on firm performance. This may be due to the fact that the appointment of independent commissioners is not based on performance (area expertise). Most independent commisioners in Indonesia are appointed due to their occupation position. Although some companies attempt to meet the conditions by selecting an independent commissioner in accordance with the criteria, but there are still many companies that do not meet minimal compliance requirements and even some companies have independent commissioners that are still questionable for their independency. Further, some of independent commissioners serve at several other public firms as independent commissioners, hence it can be assumed that independent commissioners are not able to perform the functions and roles appropriately as it is only a symbolic position. Further, the two-tier system boards that are commonly used in developing countries in particular Indonesia, is intended to minimise the occurrence of authority abuse. Mostly board of directors are generally dominated by members of the extant relatives' relationship/kinship. Moreover, large firms are mostly dominated by the family, so that the entire board and management are more likely to be managed by relatives.

The coefficient for audit committee is a negative and not significant, suggesting that the higher the blockholder ownership, the lower the firm performance. Though the audit committee are seen to be one of an important mechanisms for reducing agency costs by oversight of financial reporting, financial disclosure, regulatory compliance and risk management activities. The non significant result for audit committee may be due the fact that most firms only have three members of audit committee that solely met the minimum number required on the board (see descriptive statistics for audit committee). Further, most audit committees are not only serve in one firm, they mostly serve in several firms, hence they are unable to perform their duties and functions effectively.

The coefficient for board size is a negative and significant, suggesting that the lower the board size of directors, the higher the firm performance. This result is consistent with Yermack (1996), Barnhart and Rosenstein (1998), Liang and Li (1999), Mak and Kusnadi (2005), Garg (2007), and Cheng (2008). In Indonesia, most of the large firms tend to be owned by the group/ family group, hence the appointment of directors are often based on kinship. Therefore, not only has larger boards provided the opportunity of perquisites, but larger boards has led to higher cost. This is caused by people who do not fit to sit on the board, as they are directly appointed by the firm in accord to kinship and not expertise. The large number of board is likely to affect the coordination cost, and if these cost are not accommodated accordingly, it will eventually affect the effectiveness of management supervision (Garg, 2007). This result is consistent with agency theory perspective, that the greater the size of the board of directors, the greater the likelihood of agency problem as more and more people who will be involved in the process of monitoring and review of the actions and decisions made by management (Coles, Daniel and Naveen, 2008).

Table 4. Tobit regression result

Variables	*Coefficient*	*Std. Error*	*z-Statistics*	*Probability*
Constant	11,5080	4,4278	2,5990	0,0093
Managerial Ownership	-69,0135	31,1838	-2,2131	0,0269
Blockholders Ownership	10,6210	4,8643	2,1834	0,0290
Independent Commissioner	2,8460	7,4584	0,3816	0,7028
Audit Committee	-1,1980	0,8529	-1,4046	0,1601
Board of Directors	-0,8445	0,4888	-1,7279	0,0840

5 Conclusions

Most firms in Indonesia tend to be owned by the group or family group, hence the appointed persons sit on the board is apparently based on the kinship but not ability and expertise. This study attempts to examine the impact of board structure and ownership structure on firm performance of blue chip firms listed in Indonesian Stock Exchange. Blue chip firms are known to weather downturns and operate profitably in the face of adverse economic conditions, which help to contribute to their long record of stable and reliable growth. Therefore, it draws attention to explore whether high liquid and financially sound firms comply to the corporate governance regulations set and to investigate the impact of board structure and ownership structure on firm performance. The results reveal that apart from independent commissioner and audit committee, all variables have a significant impact on firm performance. The non significant result for independent commissioners and audit committee may be related to the ownership type of most firms in Indonesia, that is family ownership, hence, the appointment of independent commissioners and audit committee is based on the kinship and colleague's bonding. Therefore, most of them are not able to perform their functions and duties effectively. Further, independent commissioners and auditors also serve in several firms and this may limit the time spent in one firm. Therefore, the government through capital market regulatory body should strengthening the legal, judicial and tax systems, enforcing financial discipline, fostering well-regulated securities markets, building professional capacity and transparency as external sources of discipline/control for the corporate sector.

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