

# The Effect of Family Ownership and Corporate Governance on Firm Performance: A Case Study in Indonesia

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## Abstract

This quantitative study aims to examine the effect of family ownership on company performance empirically. Specifically, this study examines the moderating effect of corporate governance on the relationship between family ownership and company performance which has never been explored in the previous studies. This study's main target population was all listed companies in the Indonesian Capital Market Directory (ICMD) for 2008–2018. The study used criteria, namely data completeness, to measure research variables and obtained 2996 data or firm-year observations. The research contingency model to test the proposed hypothesis was the General Moment Method (GMM). The study presents the results of data descriptions shows the average, median, maximum, minimum, and standard deviation values for each variable. The descriptive data shows that family ownership is common in Indonesia: 64% of 244 companies in the sample. The inferential analysis results using a multiple regression model test show that family ownership significantly reduces company performance. However, corporate governance proxied by the board of directors, managerial risk profile, and independent commissioners significantly moderate the relationship between family ownership and company performance. Besides, the managerial risk profile and independent commissioners strengthened while the board of commissioners' presence weakened the effect of family ownership on performance.

**Keywords:** Firm Performance, Family Ownership, Corporate Governance

**JEL Classification Code:** G34, L21, M38

## 1. Introduction

The ownership structure is the proportion of ownership owned by each investor in a company or the composition of equity held by shareholders. Boyd and Solarino (2016) explained that ownership in a company can be seen from institutional ownership, insider ownership, block holder

ownership, family ownership, group ownership, and state ownership. Demsetz and Lehn (1985) stated that the ownership structure systematically and consistently seeks to maximize firm value.

According to Lukviarman (2004), company ownership in Indonesia is generally concentrated in a group of individuals, families, or ownership through other companies. This condition is especially found in national companies where family ownership controls the public company. Family owners have almost total control over the company by the business groups owned by their families. Claessens et al. (2000) find that majority ownership in Indonesia is owned and controlled by families. Carney and Hamilton-Hart (2015) stated before the economic crisis, family ownership dominated the company, which is more than two-thirds (68.6%) of the maximum ownership limit of 10%. After the crisis in 2008, corporations with family ownership declined even though the family ownership remained dominant (57.3%).

Previous studies show that the relationship between family ownership and company performance is varied and inconsistent. Gedajlovic and Shapiro (2002), Kapopoulos and Lazaretou (2007), and Ma et al. (2010) showed a positive

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effect on company performance. This result contradicts Fauzi and Locke's (2012) and Wang and Shailer's (2015) findings. Besides, Anderson and Fraser (2000), Martínez et al. (2007), and Chu (2011) found that family ownership has a positive effect on company performance, while Cucculelli and Micucci (2008) and Khan et al. (2005) found the opposite result.

The assumption of a direct relationship between family ownership structures is likely to cause these mixed and inconsistent results. According to Boyd and Solarino (2016), the company's ownership structure affects company performance indirectly and may be moderated by governance. Morck et al. (1988) stated that corporate governance is considered a mechanism that protects minority parties and the exploitation conducted by managers and controls the shareholders by emphasizing legal mechanisms. Baker and Powell, (2009) stated that corporate governance mechanisms consist of internal systems and external procedures which are used to ensure that agents (company management) run the company for the benefit of one or more principal shareholders and other stakeholders.

To align the owners' interests and goals, a company needs a management mechanism that ultimately improves company performance. The management mechanism, as stated by Boyd and Solarino (2016), is presenting good governance. According to Bhagat and Bolton (2019), Brown and Caylor (2009), and Mutlu et al. (2018), board independence will be useful for disciplining management to act under company rules so that that company performance will increase. This study empirically examines the effect of family ownership on company performance and analyzes corporate governance's moderation on family ownership and company performance. The research gap in this study is this study uses corporate governance as a moderator. As recommended by Boyd and Solarino (2016), this study also uses a contingency design using an indirect relationship design or model.

## 2. Literature Review

### 2.1. Underlying Theory

At least three theories are often used in assessing the existence of family ownership as a type of ownership structure, namely agency theory, information asymmetry, and stewardship theory. Agency theory examines the separation relationship between the owner (principal) and the agent (manager). Agency theory emphasizes that there must be a clear separation between operational activities and control activities that investors conduct in an organization. Activities undertaken by the Board of Directors (BoD) represent the shareholders who perform their function to control the company's activities and the Board of Management (CEO), which has company managerial function.

Agency theory also explains the existence of conflicts within the company, namely the relationship between the manager (agent) and the principal (investor) who forms a work contract and causes more agency problems. An agency relationship is a contract between the company owner (principal) and the manager as a person. They controlled the company to make the right decisions for the company owner's benefit (investor). Therefore, agency cost cannot be avoided in the relationship framework between the agent and the principal (Jensen & Meckling, 1976).

Agency theory states that agency problems will occur if the manager proportion of company shares is less than 100%. Managers tend to act in their interests and not maximize firm value in making funding decisions. Management does not bear the risk of errors in decision-making; the shareholders entirely bear the risk. Another cause of conflict is that shareholders only care about the company's systematic risk because they invest in well-diversified portfolios. In contrast, managers are more concerned about the company's risk as a whole (Jensen & Meckling, 1976).

Stewardship theory is an alternative to the agency theory view. Stewardship theory assumes that the managers are good managers of the company. Company management can be trusted and work diligently to achieve high corporate profits, which later can be enjoyed by shareholders (Donaldson & Davis, 1991). The stewardship theory of corporate governance is a normative alternative to agency theory. The stewardship behaviour of managers results in exemplary corporate governance practices when the espoused values of the firm are aligned with the enacted values. The managers can conduct the company's operating activities and work together with the principal to achieve goals (Davis et al., 1997). Stewardship theory assumes that the principal will create a corporate governance structure that can empower and motivate managers to be interested as stewards who can serve stakeholders' interests and improve company performance.

Subramanian (2018) emphasized that stewardship (stewardship) by a manager will produce an exemplary corporate governance practice when the company's values align with prevailing values, which in turn create value for shareholders. Chou (2015) argued that the company's insider ownership is supported by two arguments: the convergence of interest argument and the entrenchment argument. The interest convergence argument suggests that high insider ownership aligns the manager's interests with outside shareholders, positively affecting firm performance.

The separation of ownership and management in a company will create a conflict of interest due to the objectives' misalignment. Agency problems between principal and agent are usually caused by differences in each principal and agent (managerial). The crux of the issues is when companies are not managed directly by their owners,

but managers hired to act on their behalf and tend to pursue their interests, which are different from the principal's interest (Jensen & Meckling, 1976). In general, the agent will have more complete company financial information than the principal (information excellence).

In reality, company managers have more information than is available to outside investors. This condition is called asymmetric information. There is an assumption that managers generally have limited knowledge of the stock market and future interest rates. Still, they generally know more about the company's prospects than investors or investment analysts. This situation allows the emergence of asymmetric information. In this case, the company's management believes that the company's shares are undervalued or overvalued, depending on whether he thinks the information is profitable or not.

## **2.2. Ownership Structure and Company Performance**

Healthy company performance can be achieved when the company is professional and well managed. The company's superior financial performance is a way to satisfy investors (Chakravarthy, 1986), which can be represented by profitability, growth, and market value (Cho & Pucik, 2005; Ramanujam & Venkatraman, 1986). To achieve corporate value, investors generally give the management to the professionals.

The dominant paradigm of ownership structure is based on Berle and Means (1932), who stated that the separation of ownership and control negatively affects firm performance. Various arguments explain the contrasting effect of ownership structure on firm performance. Some authors also believe that firm performance also determines ownership structure, and the relationship between firm performance and ownership structure is endogenous.

The ownership structure of Jensen and Meckling (1976) suggested a positive relationship between manager ownership and firm value. However, the empirical test conducted by Demsetz and Lehn (1985) does not find a positive relationship between ownership structure and firm value. Most likely, the relationship pattern between manager ownership and firm value is not a simple linear relationship. Demsetz and Villalonga (2001) did not find a significant relationship between ownership structure and firm performance. This finding is consistent with the view that pervasive ownership exacerbates some agency problems and benefits compensation that generally compensates the problem.

Stulz (1988) and Morck et al. (1988) developed ownership structure theory and found that the relationship between managerial ownership and company value is non-monotonic. When the manager's ownership level increases,

the company's value will increase because at that time, the manager's incentive to act "consumptive" decreases. At a high level of managerial ownership, company value will finally decrease. The increase in manager ownership is due to the influence of management entrenchment, which is a position of ownership when managers freely maximize their utility without fear of hostile takeover, resistance from the board of commissioners, or resistance from large shareholders.

Meanwhile, Welch (2003) showed that ownership structure is significant in explaining performance. Phung and Mishra (2015) found a non-linear relationship between ownership structure and company performance. State ownership has a convex relationship with company performance. They found that company performance increases beyond the state ownership level of 28.67 percent. Foreign ownership has a concave relationship with company performance. They found that firm performance increases with foreign ownership increasing to 43 percent and then decreasing. Decision-makers must encourage foreign ownership and the spread of state ownership can improve company performance.

Anderson and Reeb (2003) found that more than one-third of companies listed in the S&P 500 are family companies. Barontini and Caprio (2006) examined 675 registered companies in 11 European countries and found that 53% of the total sample is family. A survey conducted by PwC found that family-owned companies mostly dominate companies in Indonesia and the world. Juanda and Jalaludin (2018) suggested that family ownership also has potential weaknesses. This result is in line with Fama and Jensen (1985), who stated that family interests are not always in line with other shareholder's interests. A combination of management and control in the family's hands can lead to investment decisions that are not optimal. Demsetz and Lehn (1985) argued that the family can pursue personal gain by control the money. According to Shleifer and Vishny (1997), family executives may remain active in the company even though they are no longer competent (entrenchment effect). Andres (2008) found that family ownership different from other types of large shareholders when they are board members. As board members, the family may have deeper relationships with companies they managed or may even feel responsible for other shareholders.

## **2.3. Hypothesis Development**

A company with a family ownership structure is a company controlled and run by the family through a percentage of share ownership dominated by family members or family members' existence as the company's board of directors (Anderson & Reeb, 2003). Share ownership in developing countries is mostly controlled by family ownership, including companies in Indonesia (Claessens et al., 2000).

Studies on family ownership structure associated with company performance have resulted in mixed conclusions. Family ownership does not have a significant effect on company performance (Juanda & Jalaludin, 2018). In Romania, family ownership has a weak relationship with company performance, while in Germany, family ownership has a positive relationship with company performance (Schank et al., 2017). Margaretha and Marko (2013) compared family and non-family firms' performance in Indonesia where the sample is taken from 31 consumer goods companies listed on the Indonesia Stock Exchange, ranging from 2005 to 2009. They found that non-family companies perform better than family firms, and there is no significant effect between family ownership and company profitability.

On the other hand, family ownership has a negative contribution to the company's market valuation. This study showed that family firms have lower financial performance than non-family firms. This result is in line with Lee et al. (2018) and Schank et al. (2017) that there is a significant negative relationship between family ownership and company performance. Demsetz and Lehn (1985) also supported this negative relationship, stating that the family can pursue personal gain from money control. According to Shleifer and Vishny (1997), family executives may remain active in the company even though they are no longer competent (entrenchment effect). Based on this description, the following hypothesis can be proposed:

**H1:** *Family ownership has a negative effect on the company performance.*

Anderson and Reeb (2003) proved that the family ownership structure is an efficient organizational structure because it has higher performance than non-family firms. Based on the "founder effect", the founder can substantially affect the company through unique abilities, leading to considerable performance.

The independent board of commissioners' role in the company is to supervise all activities to achieve performance and ensure accountability. In contrast, the board of directors will conduct the operationalization of the company's activities to be responsible for the company's performance. Chu (2011) stated that the effect of family ownership may materialize when family ownership is combined with active management and family control. Besides, the relationship between family ownership and firm performance is stronger in small and medium enterprises (SMEs) than in large companies. Margaretha and Marko (2013) proved that family ownership negatively contributes to the company's market valuation. These findings indicate that family firms have lower financial performance than non-family firms. Family members in

the top position have the main control right and negatively contribute to its performance. Based on this description, the following hypothesis can be proposed:

**H2:** *The Independent Commissioner strengthens the effect of family ownership on company performance.*

A survey conducted by Claessens et al. (2000) found that a family-owned company dominates most companies in Indonesia and the world. Juanda and Jalaludin (2018) suggested that family ownership also has potential weaknesses. As stated by Fama and Jensen (1985) that family interests are not always in line with the interests of other shareholders. A combination of management and control in the hands of the family can lead to investment decisions that are not optimal. Demsetz & Lehn (1985) argued that the family can pursue the personal gain of money control. According to Shleifer and Vishny (1997), family executives may remain active in the company even though they are no longer competent (entrenchment effect). Andres (2008) stated family ownership may be different from other large shareholder types when they are a board member. As board members, the family may have deeper relationships with companies they manage themselves or may even feel responsible for other shareholders.

Sustainable family business success requires active teamwork involving owners, managers, and the board of directors. The owner or the founder company certainly wants the company to exist in the long run. For this reason, professional management is needed to achieve company goals. Based on this description, the following hypothesis can be proposed:

**H3:** *The Board of Directors strengthens the effect of family ownership on company performance.*

Lee et al. (2018) argued that small family ownership takes less risk to pursue their gain. More extensive family ownership will align their corporate interests by taking on more value that increases risky projects. Nguyen (2012) investigated Japanese family-owned firms and found that family control and concentrated ownership are positively related to corporate risk-taking. Based on this description, the following hypothesis can be proposed:

**H4:** *Managerial Risk Profile strengthens the effect of family ownership on company performance.*

### 3. Research Method and Materials

This study is conducted on companies listed on the Indonesia Stock Exchange from 2010 to 2018. The sample companies are non-financial companies in 9 industrial

sectors. The companies must meet specific criteria to become a sample. Table 1 presents the number of companies that fulfill the criteria. The sample obtained 224 companies which resulted in 2996 data (firm-year observations).

This study's type of data is quantitative data, expressed by numbers that indicate the value of the magnitude or variable. This study's data source is secondary data, namely the company's annual report published by the Indonesian Stock Exchange. The used variables consist of the dependent variable, independent, and control variable with measurement proxies and reference sources, as shown in Table 2. To test the hypothesis, this study uses statistical equations as in equation 1. From this equation, the efficiency of  $\beta_1$  is expected to be negative while the coefficient  $\beta_1$ – $\beta_5$  expected to be positive.

$$\begin{aligned} \text{Tobin } Q = & \beta_0 + \beta_1 \text{KKLG}_{it} + \beta_2 \text{FS}_{it} + \beta_3 \text{DR}_{it} \\ & + \beta_4 \text{CR}_{it} + \beta_5 \text{KKLG}_{it} * \text{DKIND}_{it} \\ & + \beta_6 \text{KKLG}_{it} * \text{DD}_{it} + \beta_7 \text{KKLG}_{it} * \text{PRM}_{it} + e_1 \end{aligned} \quad (1)$$

**Table 1:** Sample Determination

No	Descriptions	Amount
1	Companies listed in 2010	391
2	Financial company	(60)
3	Non-financial companies	331
4	Companies with incomplete annual reports	(87)
	The number of companies that complied	244

**Table 2:** Research Variables

No	Variable	Measurement	References
1	Company performance (Tobin Q)	Tobin Q	Bhagat and Bolton (2019), Delen et al. (2013)
2	Family Ownership (KKIG)	Dummy 1 when there is ownership above 10%, otherwise 0	Juniarti and Valentino (2017) and Habtoor, (2021)
3	Independent Board of Commissioners (DKIND)	The percentage number of independent commissioners compared to the number of commissioners	Kusuma and Ayumardani (2016)
4	Board of Directors (DD)	The number of the Board of Directors in a company	Zubaidah et al. (2009) and Zabri et al. (2016)
5	Profile Risk Managerial	The proportion of research and development costs to total assets	Yung and Chen (2017)
6	Firm Size (FS)	The logarithm of total assets	Lopez-Valeiras et al. (2016)
7	Leverage (DR)	The proportion of total debt to total assets	Mursalim et al. (2017) and Cahyo et al. (2021)
8	Liquidity	The proportion of current liabilities to current assets	Demirgünes (2016)

Where:

- Tobin  $Q$  = Company performance
- $\beta_0$  = Constant
- $\beta_i$  =  $i^{\text{th}}$  Regression Coefficient
- KKLG = Family Ownership
- DKIND = Independent Board of Commissioners
- DD = Board of Directors
- PRM = Managerial Risk Profile
- FS = Firm Size
- DR = Leverage
- CR = Liquidity

#### 4. Results and Discussion

This section presents the study results of data descriptions and hypothesis testing. Table 3 shows the data description, namely the average, median, maximum, minimum, and standard deviation values for each variable. Table 3 shows that family ownership is common in Indonesia. The results show that from 244 sample companies, 64% or 157 companies are family companies. This finding means that family ownership maintains its existence by not selling its shares to the public in large numbers. This context is a strategy of family owners to retain control over the company so that their rights do not shift to other owners. Family owners tend to take personal benefits from the company. The more stock value invested, the easier it is to control the company.

Table 4 shows the results of hypothesis testing using equation 1. The equation is processed by the Generalized Method Moment model (Hansen, 1982). The advantage of

**Table 3:** Data Description

Variable	Mean	Median	Maximum	Minimum	Std. Dev.
Tobin Q	225.505	119.59	28809.620	10.330	988.841
KKLG	0.640	NA	1.000	0.000	NA
DKIND	40.812	40.000	80.000	25.000	10.041
DD	4.885	5.0000	15.000	2.000	2.016
PRM	0.024	0.010	0.220	0.000	0.035
FS	28.583	28.655	33.470	22.350	1.817
DR	63.578	51.173	1184.420	0.850	80.241
CR	18.8577	1.660	766.980	0.010	50.664

**Table 4:** Hypothesis Results

Main Variables	Coefficient (Standard Error)	Expected Sign	Hypothesis
Constant <sup>a</sup>	1720.396* (-307.128)		
KKLG	-312.412** (-155.867)	-	H1 is supported
KKLGDD	-83.3741** (-50.634)	+	H2 fails to support
KKLGDKIND	157.841** (-89.669)	+	H3 is supported
KKLGPRM	53.785** (-22.378)	+	H4 is supported
<b>Control Variables</b>			
CR	0.994** (0.584)		
FS	-53.310* (10.168)		
DR	1.151* (0.146)		
R-squared = 0.8229			
Adj. R-squared = 0.8225			

using the Generalized Method of Moment (GMM) estimator is that it is possible to detail testing parameter uncertainty, namely testing unknown parameters that must be predicted (Bontemps & Meddahi, 2005). Another advantage of the GMM method is that it does not require specific assumptions regarding the observed stochastic variables when estimating model parameters. The existing number of moment conditions will exceed the number of model parameters (Jagannathan et al., 2002).

Anderson and Reeb (2003) defined family ownership as company ownership by family members. The company is usually controlled through family members who sit in management either as directors or as commissioners. The result in table 4 shows that family ownership has a negative and significant effect. The results show that the family-owned company positively impacts company performance,

although it was not substantial. The findings also indicate that the family company's performance is different from the performance of non-family companies. This study's results are not in line with Margaretha & Marko (2013); Juanda & Jalaludin (2018), which state that the performance of family-owned companies is not different from the performance of non-family ownership companies.

Table 4 also shows that the independent board of commissioners moderates family ownership's effect on company performance. Family ownership is the ownership of the company by the family and or their descendants. The independent board of commissioners in the company has a role in overseeing all activities to achieve performance and ensure accountability. In contrast, the board of directors will conduct the operationalization of company activities to be responsible for company performance (Chu, 2011).

The existence of independent commissioners in a company has two main reasons. First, more than 50 percent of company ownership in Indonesia is owned by families. When less professional family members hold the company's management, the opportunity for conflict is more significant. Therefore, the Independent Board of Commissioners (GDD) presence in a company is expected to be the supervisor and advisor for the company's activities so that all party's interests can be accommodated. Second, a phenomenon occurs in Indonesia that the ownership structure of companies in Indonesia is still concentrated (Tulung & Ramdani, 2018). This made a possibility of a conflict of interest between the majority and the minority. It is necessary to have an independent board as a minority representative to resolve the conflict of interest.

Table 4 shows that the board of directors significantly moderates the effect of family ownership on company performance. This result can be interpreted that the board of directors as a governance mechanism may have helped protect minority shareholders. According to Maseda et al. (2019), high family ownership creates an incentive for controlling shareholders to take over wealth from minority shareholders. Therefore, according to Lukviarman (2016), the board of directors has a role as a bridge between shareholders as the company owner and management as the party that will conduct the company's activities. This situation may imply that the board of directors' role is to ensure that the corporation has been well executed to achieve the company's goals. The family company usually places a board of directors that comes from that family member.

Finally, Table 4 indicates that the managerial risk profile significantly moderates family ownership's effect on firm performance. It can be interpreted that the managerial risk profile encourages family ownership in pursuit of profits through taking profitable investment projects. This result can also be interpreted that small family holdings take less risk in pursuit of their benefits. Meanwhile, more extensive family ownership will align their corporate interests by taking on more value that increases risky projects (Lee et al., 2018). Zhao and Xiao (2016) proved that when the ownership of the largest shareholder decreases, these shareholders can prevent company risk-taking. However, when the largest shareholding increases beyond the threshold, it encourages company risk-taking due to the dominance of the incentive alignment effect.

## 5. Conclusion

Companies in Indonesia are generally family-owned companies (64%). The existence of this family ownership significantly decreases the company's performance. The presence of corporate governance proxied by the board of directors, managerial risk profile, and independent commissioners significantly moderate the relationship between

family ownership and company performance. More specifically, the managerial risk profile and independent commissioners strengthened while the board of commissioners' presence weakened the effect of family ownership on performance.

The results of this study have several implications. Theoretically, this study examines the corporate governance mechanism in the form of independent commissioners and board of directors by placing it as a moderating variable that has never been tested in previous studies. The results of this study support the research model developed from agency theory and stewardship theory and explain the relationship of family ownership to company performance. Study findings enrich the literature and develop financial management theory. Furthermore, company management is responsible for the company's success to maximize company value. Corporate governance is essential in realizing the company's goals. The results show that the moderating variable of corporate governance strengthens family ownership's effect on company performance. The presence of corporate governance improves company performance. Therefore, company management should maintain the implementation of corporate governance under existing regulations.

Furthermore, the board of directors' existence as the spirit of the company strengthens the effect of concentrated ownership on company performance. The implication is that the board of directors can conduct its function effectively in directing and controlling management to protect investors' interests. The board of directors is committed to realizing its goals through its role as an executive in managing and running the company. Furthermore, the family ownership structure strengthened by the presence of independent commissioners can improve company performance. This result means independent commissioners can conduct their function as a supervisory board that controls the company activities, so that company performance increases. Finally, the managerial risk profile encourages family ownership in pursuit of profit through taking profitable investment projects. Therefore, company management needs to conduct a strategy based on a competitive advantage that minimizes business and company-specific risks.

This study examines a research model that links family ownership to company performance moderated by corporate governance. Further study needs to include ownership structures such as government ownership, concentration, institutional, and foreign ownership while using the corporate governance variable as a moderating variable.

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