

# **Bad Board Governance, Family Domination, Agency Problems, and Its Evidence in Indonesian Listed Companies**

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## **Abstract**

*The ownership structure of the Indonesian Listed Companies tends to be concentrated, and family is the dominant controller. The family domination causes agency problem to non-family investor. By investigating the same sample of listed companies in Jakarta Stock Exchange in 1996 and in 2000, this research discovers that the reduction of family ownership will decrease agency problem. The optimal portion, the reduction of family ownership 20.0%. However, after achieving that portion, the reduction of family ownership will increase the agency problem. This research also finds that family is not the best controller. Meanwhile the bonding mechanism that effectively reduce agency problem is the increasing of dividend payment, not be increasing of debt.*

Key words : agency problem, family ownership domination, bonding affectivity.

## **Introduction**

In general, the ownership of listed companies tends to be concentrated in which family and financial institution is the main controller. This phenomenon is not only occurring in the developing countries but also in the advanced countries by the exceptions of the United States of America and the United Kingdom. A survey conducted by La Porta et al ( 1999 ) in 27 advanced countries found that of 64% of listed companies that have concentrated, 30% of them is controlled by family.

In Indonesia, most of listed companies are also concentrated owned by family. A Survey conducted by Claessens, Djankov, and Lang ( 2000 ) found that

Vol. 12, No. 2, December 2004

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family owns 71,5% of Indonesian listed companies. Is there any problem due to the ownership structure? Kurniawan and Indriantoro ( 2000 ) argued that due to the family domination in Indonesian listed companies is one of the factors why the application of good corporate governance have not effective yet in Indonesia. They argue that if Indonesian listed companies are still dominated by family, the protection of minority investors will be remaining weak.

Conflict of interest between minority investors and the dominant family investor is one of versions in agency problem, and the scholar has not given proper intention. They frequently investigate the conflict of interest between investors and manager. This is because most of researches are conducted in the US and the UK in which agency problem emerges between investors and manager. Therefore the mechanism that theoretically and empirically was proved to reduce agency problem must be tested in Indonesia. Bonding mechanism by increasing dividend or debt suggested by Jensen ( 1986 ) has not effective applied in Indonesia.

By using data of the United States Listed companies, Fama and Jensen (1983) argued that monitoring cost to reduce agency problem in companies controlled by family tends to be lower than controlled by non-family. Meanwhile McConoughy *et al* ( 2001 ) found that family-controlled companies tends to have higher market to book value of equity than that of non-family's controlled companies. If we do not investigate the difference of ownership structure from both findings, we will have misperception that the family-controlled companies are more effective than non-family's controlled companies to overcome agency problem in Indonesia as Kurniawan and Indriantoro ( 2000 ) hypothesized.

By using listed companies in 1996 and 2002, this study found that the reduction of family ownership in the beginning what would decrease agency problem. However after achieving the given portion, the decreasing of family ownership portion will increase agency problem. This research also finds that in overcoming the agency problem, family's controlled companies is not as good as of financial institution companies and State's controlled companies although it may have a bias in industrial advantage. In relation of bonding mechanism, this research found that, by increasing dividend, is effective to reduce agency problem. Moreover in 1996 the increasing of debt had caused the increasing agency problem.

## **Family Ownership versus Manager Ownership**

Jensen and Meckling ( 1996 ) in the US introduced systematical analysis on agency problem. They developed a model related to the manager ownership in which is managed. Jensen and Meckling defined  $\alpha$  as a portion of stock owned by manager. If  $\alpha = 1$  the company is wholly owned by manager. Consequently he or she will bear all risk when the company is under performed. On the other side, if  $\alpha < 1$  the manager will bear the  $\alpha$  from its mistake, and the remaining  $(1 - \alpha)$  will be transferred by other investors. The lower the portions of her stock the smaller the attention to increase value of the company. Moreover managers may take actions that give personal benefit by sacrificing other investors.

One of mechanisms suggested to reduce agency problem between manager and investor is that manager must have higher portion of stock. This is because the higher the portion, the more responsible the manager to increase the value of companies.

This solution cannot be applied in Indonesia because there is a difference root of agency problem. In Indonesia, the portion of manager is usually high because he/she is also the member of family who control the company. To overcome the agency problem, the solution is not to increase the ownership portion but to reduce family's portion.

The question is why the family's portion must be reduced? Stulz ( 1988 ) improved the agency theory originated by Jensen and Meckling ( 1976 ). He argued that the relation between manager's ownership and value of company is non-monotonic. In the low  $\alpha$ , the increasing of manager ownership tends to increase value of the company. Conversely when  $\alpha$  is high, the increasing the manager ownership will increase agency problem, in turn, it the value of entrenchment, an ownership position in which manager is freely follow personal interest without any anxiety from strike from other investor through hostile take over or proxy fights. In the Indonesian cases, because family ownership portion is still in this position, the portion must be reduced to decrease agency problem.

## **The Influence of Family Ownership on the agency Problem**

LA Porta et al ( 1999 ) and Claessens et al ( 2000 ) defined family as all individuals and companies whose ownership is documented, except the owners are listed companies, or financial institution. Individuals and companies who

have so small ownership that cannot be documented is categorized as listed. These researches use this definition.

This research classified family ownership portion to be 5 categories : Less than 5,00%, 5,00% - 10,00, 10,01 – 20,00%, 20,01 – 50,00% and > 50%. Family ownership portion less than 5% is treated as reference group.

The increasing performance points out that the manager is able to minimize agency problem. In this research, the performance is measured by two proxy (1) weekly cumulative abnormal return for one year without dividend adjustment ( notify by CAR ) and (2), weekly cumulative abnormal return for one year with dividend adjustment ( notify by CARADJ ). Abnormal return is the difference actual return and market return. The using of abnormal return as a proxy of companies performance is will represent the trading stock that is similiar with a tournament. Every stock will “presence” as good as possible, and investor will act a “jury” that will determine which stock is the best. Stocks that have positive abnormal return will have better performance. Conversely when the stocks have negative abnormal return, it has bad performance.

The test model of the influence family ownership on the reduction agency problem uses two control variables that are market value of equity ( MVE ) and book to market value of equity ( BME ). The using market value of equity as a control variable is based on previous research in which market value of equity has significantly influence on return of company ( Kim, Lee, and francis, 1988; Cruthley and Hansen, 1989; Volpin, 2002; and Milton, 2002 ). Where as Fama and French ( 1992 ) added BME as a variable that influence return of company.

The research investigates listed companies in Jakarta Stock Exchange in early 1996 and still listed until the end of 2002, and the analysis is conducted only for the year of 1996 and 2002. The using of 1996 as an early analysis is to have description the relationship of pattern family ownership and the reduction agency problem before economic crisis, while the using of 2002 data is to show the relationship that pattern after economic crisis. In the early 1996, there were 238 companies listed in Indonesia Stock Market, but only 213 companies remain in the end of 2000.

**Table 1 : The Result of Relation Test Between Family Ownership and The Reduction of Agency Problem**

$$\text{Model : CAR}_i = \alpha + \beta_1 \text{ DOWN2}_i + \beta_2 \text{ DOWN2}_i + \beta_3 \text{ DOWN3}_i + \beta_4 \text{ DOWN4}_i + \gamma_1 \text{ LnSize}_i + \gamma_2 \text{ BME}_i +$$

(1)

Where, CAR is weekly cumulative abnormal return for 1 year, CARADJ is cumulative abnormal return with dividend, DFWN 1 is dummy variable that has "1" mark for the company that have family ownership 5-10%, DOWN2 is for ownership portion 10,1 –20%, DOWN3 is for 20,1-50%, DOWN4 is for >50% ownership, LnSize is ln of market value of equity, BME is book to market value of equity, DYEAR is dummy variable with "0" mark for 1996 and "1" for 2000. The following table points out the influence family ownership portion on the reduction of agency problem.

Independence Variable	Dep. Var : CAR		Dep. Var : CARADJ	
	Koef	Prob	Koef	Prob
C	-2.1748	0.036	-1.9877	0.058
DOWN1	0.2562	0.421	0.2181	0.498
DOWN2	0.7123	<b>0.051</b>	0.6588	<b>0.074</b>
DOWN3	0.0747	0.537	0.1567	0.255
DOWN4	0.0524	0.603	0.0280	0.784
LSIZE	0.3842	<b>0.019</b>	0.3609	<b>0.030</b>
LSIZE^2	-0.0183	<b>0.004</b>	-0.0174	<b>0.007</b>
BME	0.0059	0.181	0.0063	0.160
DYEAR	0.0915	0.132	-0.0119	0.846

Empirical test model used had been changed from the initial model. This is because RAMSEY test points out that the initial model has experienced the specification mistake on lnSize variable, hence this was modified by adding lnSize^2. The using White – heteroskedasticity test does not show any heteroscedasticity in this model. Meanwhile autocorrelation test using Ljung-Box Q Statistics points out there is no autocorrelation within the model.

Table 1 points out that the using either dependent CAR variable or CARADJ gives the similar result. This show that performance proxy used in this research is reliable. Both model show that DOWN2 coefficient is positive significant, while dummy variable for family ownership is not significant. These finding

show that family ownership between 10.1 – 20% is the best portion to reduce agency problem.

The investigation on dummy coefficient points out that  $DOWN4 < DOWN3 < DOWN2 > DOWN1$ . This pattern interprets that the decreasing of family ownership in the beginning will reduce agency problem, but after reaching beyond portion of 10.1 – 20.0%, the reduction family ownership will increase agency problem.

The influence of economic crisis on the degree of relationship between the reduction family ownership and the reduction agency problem is relatively constant. This is shown by year dummy variable of BME is not significantly influence cumulative abnormal return. Where as the size of company have parabolic significant influence on cumulative abnormal return. This finding points out that the big-size companies are not able to companies with small-size companies because the growth rate the small companies are higher than that of large-size companies, the small-size companies are more able to create added value.

To test robustness the finding, the research modifies definition of family with another modification. First, family defined by only individual whose ownership is recorded. Consequently the ownership of closed-company is excluded from this criterion. Second, family is defined as one individual or company whose ownership is dominant. This definition is used to avoid the possibility not to have family relationship between individual component and the form.

By using both modified family definitions, it is still found that the pattern that the reduction of family ownership in the beginning can be able to reduce agency problem, but after reaching a specific portion the reduction of family ownership will make agency problem increases. The emerging difference on the modify family definition is on gradation degree of reduction and the increasing agency problem when the family ownership decrease. In the family definition that only includes individual ownership. This finding indicates that the relation family ownership that consists of individuals is more closely than those companies.

In the definition of family that include only one dominant owner among individual owners or companies, the degree of gradation of decreasing / increasing agency problem because of the decreasing the family ownership is less than those other definition. Even with the definition hypothesizing inter-component family ownership is independent, it is not found that ownership portion that is significantly the decreasing its agency problem is better than other ownership is independent is bias. The decreasing of only one owner is not

cause the decreasing agency problem significantly because other owner is not decrease.

**Family Domination versus Non-Family Domination and the reduction agency problem.**

This research finds that in 1996, as many as 85.85% of listed companies are controlled by family, 9.91% by listed company, 1.89% by State, 1.89% by financial institutions, and the remaining of 0.47% has no dominant controller. The control definition used in the research is 20% while the family definition used in this research is the definition that includes all individual and closed-company. In 2000, the condition was changed. Companies controlled by family, listed company and financial institution decrease to 84,06%,7.73%, and 0.97% respectively, and companies controlled by State and no dominant control increases to 4,48% and 2.42% respectively.

The reality that almost all listed companies in Indonesia has dominant controller raises a question; "Who are the best controller that is able to reduce agency problem?" Table 2 points out the result of regression model including dummy variable on family contro (DFOWN), financial institution control (DIOWN), State control (DSOWN), listed company control (DCOWN),and the group of companies having no dominant control as reference group.

Table 2 points out that the family-controlled companies are not significant to reduce agency problem. This result is different with companies that have no dominant controller. Even when dependent variable CAR used, coefficient DFOWN is negative. It indicates that the family-controlled companies tend to be worse in decreasing agency problem although the vale is not significant. From the table also indicates that listed controlled is as bad as family-controlled companies in overcoming agency problem. Meanwhile State-controlled companies and fnancial institution-controlled companies have better performance to handle agency problem. From year dummy coefficient points out that in general the handling agency problem by those controller tended to be worsen in 2002.

**Table 2 : The result of test of the influence of family domination  
Onership and non-family ownership on the reduction of  
Agency problem**

$$\text{Model : CAR}_i = \alpha + \beta_1 \text{DFOWN}_i + \beta_2 \text{DIOWN}_i + \beta_3 \text{DSOWN}_i + \beta_4 \text{DOWN}_i \\ + \gamma_1 \text{LnSize}_i + \gamma_3 \text{LnSize}^2_i + \text{DYEAR}_i \quad (2)$$

where CAR is weekly cumulative abnormal return for 1 year, CARDJ is cumulative abnormal return with dividend, DFOWN 1 is dummy variable that has 1 mark for the company that have family ownership DIOWN is dummy variable that has 1 mark is controlled by financial institution, DSOWN is variable that has 1 mark when State control, DCOWN is variable that has 1 mark when listed company, LnSize is In market value of equity, BME is book to market value of equity, DYEAR is dummy variable that has null mark for 1996 and 1 mark for 2000.

Indep. Var.	Dep. Var : CAR		Dep. Var :CARADJ	
	Koef	Prob	Koef	Prob
C	-2.3846	0.031	-2.3982	0.033
DFOWN	-0.1202	0.729	0.0675	0.848
DIOWN	0.4456	0.247	0.6516	<b>0.096</b>
DSOWN	0.7155	<b>0.028</b>	0.8990	<b>0.006</b>
DCOWN	-0.1774	0.630	0.0088	0.981
LSIZE	0.4519	<b>0.007</b>	0.4257	<b>0.013</b>
LSIZE^2	-0.0213	<b>0.001</b>	-0.0202	<b>0.002</b>
BME	0.0058	0.187	0.0055	0.210
DYEAR	0.6983	<b>0.010</b>	-0.7671	<b>0.005</b>

*The Finding family -controlled companies are not different not or even worse than reference group (companies without dominant control) is consistent with previous finding. The decreasing of family ownership than can be able to reduce agency problem must be up to 10,1-20% portion. However, when the portion on the ownership increases the agency problem is also increase Comparing family ownership 20% or more and companies having family ownership 20% or less. Because part of reference group consist of companies that has the most conducive to decrease agency problem (that is family ownership of 10,1-20%), it is clear that family-controlled company is worse than companies in the reference group.*



How with a finding that listed-controlled companies are not significantly difference with reference group? The listed companies controlled by listed companies have the same characteristic with family-controlled company. In addition, financial institution-controlled company, using CARADJ dependent variable, is probably caused by the more independent it has than family control companies. Other possibility is any divided bias included in measuring CARADJ. This is because the long-term investors tend to expect dividend rather than capital gain.

The finding that state-controlled company is better to decrease agency problem must be interpreted cautiously. The advantage of state control in only occurs is only on state listed companies. The agency problem that has been reduced is limited only on the conflict between state majority owner and other minority investor, not between state and other stakeholders. In addition, the possibility that state of any bias industrial characteristic of the listed state owned company.

**Bonding Effectiveness in The Indonesian Capital market .**

Jensen (1986) argued that bonding mechanism used to reduce agency problems is by making decisions that reduce free cash flow. The smaller cash flow the smaller opportunity to use the cash flow for personal interest. On the other words agency problem will decrease when the free cash flow smaller.

There are two ways to reduce free cash flow that is by increasing debt and by increasing dividend payment. The more debt, the more funds used to pay principle and interest. Whereas, the more dividends paid, the smaller fund available to finance company operation.

The result of empirical test for dividend and debt bonding affectivity in Indonesian Capital Market is shown in Table 3.

**Table 3 The Result Of Dividend And Debt Bonding Effectiveness**

$$\text{Model : CAR} = \alpha + \beta_1 \text{DER} + \beta_2 \text{DY} + \beta_3 (\text{DFOWN} * \text{DER}) + \beta_4 (\text{DFOWN} * \text{DY}) \\ \text{Lnsize} + \beta_5 \text{BME}_1 + \varepsilon$$

Where CAR is weekly commutative abnormal return for 1 year, DER is debt to equity ratio. By is dividend yield. DFOWN is dummy variable that has 1 mark for family-owned company, in Size is Ln Market value of equity. BEM is book to market value of equity.

Van	Dep Var : Car		Dep. Var : CARADJ	
	Koef	Prob	Koef	Prob
C	-1.7215	0.070	-1.5102	0.103
DER	-0.0512	0.046	-0.0513	0.037
DY	1.9679	0.068	2.7173	0.019
DFOWNDER	0.0527	0.035	0.0505	0.026
DFORWN*DY	0.7297	0.612	0.8043	0.600
LSIZE	0.3187	0.038	0.2837	0.062
LSIZENG	-0.0166	0.010	-0.0142	0.021
BME	0.0059	0.033	0.0056	0.074
DYEAR	-0.0281	0.694	-0.1477	0.058
DYEAR*DER	0.0442	0.091	0.0442	0.110

**Notes :**

The Model with dependent variable CAR uses white Heteroscedasticity - Consistent Standard Error & Covariance coefficient. While model with dependent variable CARADJ uses Newey-West Standard Error & Covariance coefficient.

*Table 3 points out that DER coefficient is negative significant. This means that in 1996 the increasing of debt is not only effective to reduce agency problem. But also it increases agency problem. This inconsistent finding with the agency theory probably because the debt is obtained from the bank under the same group of the company. Therefore the credit feasibility and monitoring the use of debt is weak.*

*Mean white . DFOWN\*DER is positively significant. This indicates the negative effect from the increasing debt tend to be neutralized when the company controlled by family. The positive coefficient of DYEAR\*DER points out that in 2000, the negative affect of increasing debt is significant decrease. Moreover in the family-owned company the influence of debt is change to be positive to reduce agency problem.*

Table 3 also points cut that DY coefficient is positively significant. This indicate that in general the in general the increasing of dividend is effective to decrease agency problem either in 1996 or 2000. The exclusion of DYEAR\*DY variable in the Forward Method analysis model is a proof that there is no difference pattern and intensity of influence increasing of dividend payment on the reduction of agency problem between 1996 and 2000. In addition, positive DFOWN\*DY coefficient but not significant indicates that by increasing dividend in the family controlled company is more effective than non-family controlled company. However the differences of affectivity is not significant.

## **Conclusions**

Agency problem of listed companies in Indonesia can be decreased when the family dominated ownership is reducing. Every reduction of family ownership can decrease agency problem, however the optimal reduction is between 10.1 % - 20%. The portion is the best ownership because the more reduction of the ownership it tends to increase agency problem.

Family is not the best controller compared to listed company, financial institution or state. Even financial institution and state tend to have better control on agency problem than family control although there is bias on industrial advantageous on the listed State Owned Company.

Bonding mechanism by increasing debt is clearly not effective to decrease agency problem. In 1996 the debt increasing has increase agency problem. In addition bonding by increasing dividend in general is effective to decrease agency problem.

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