

CORPORATE CONTROL, AGENCY PROBLEM AND BOARD COMPOSITION: EVIDENCE FROM INDONESIA

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Abstract

The study investigates the impact of agency problem and the distribution of corporate control on board composition using a dataset consisting of 190 listed firms in Indonesia. The conceptual framework is derived from agency theory assuming that board composition is endogenously determined by firm's specific environment. The study reveals that corporate control drives the composition of the board. The different types of large shareholders are found to pursue different strategies in relation to the board composition. While domestic and foreign investors rely on independent board, controlling family prefer to structure a less independent board. This suggests that the battle for corporate control between controlling family, in one side, and unrelated domestic and foreign investors begins with the structure of board. The findings imply that the type of large shareholder does matter in determining the device of corporate control.

Keywords: Board Composition, Agency Problem, Corporate Control, Ownership Structure

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1 Introduction

The determinants of board of director's composition have received attention from academician (Acero Fraile & Alcalde Fradejas, 2014; Hearn, 2015). One stream of research addresses the issue of board formation in a specific setting such as high tech industry (Hülsbeck & Lehmann, 2012), specific institutional setting (Hearn, 2015), and government regulation (Chen, 2014). Another stream of research focus on the US market and claim that the composition of the board might be attributable to the investment opportunity set (Hutchinson & Gull 2004), and the quality of advisory role (Coles, Daniel & Naveen, 2008). Those US studies rely on the presumption that the board of directors is an internal monitoring institution endogenously determined by firm's specific environment suggesting that the composition of the board might vary across firm (Hermalin & Weisbach 2003).

However, the US results may not be generalized to other countries because of the different institutional settings that might exist (Vafeas and Theodorou, 1998). The US-based study commonly hinges on the presence of effective monitoring by the market and a dispersed ownership where agency problem stems from the conflict between outside shareholders and managers (La Porta et al. 2000). By contrast, the institutional setting of Indonesia hinges upon an inefficient capital market and concentrated corporate ownership where agency problem emerges from the divergence of interests between those of controlling owners and minority shareholders (Asian Development Bank 2000). Consequently, the determinants of board structure in Indonesia are open empirical question.

The study investigates the impact of agency problem and corporate control on the board composition. Particularly, the study examines the relationship between prior firm performance, firm's size, and the level of ownership by different type of large shareholders and board compositions. The conceptual framework borrows from agency theory while the ontological choice follows positivism school of thought. The analyses reveal that board composition is determined by ownership structure, instead of

prior firm performance. The study finds that the different types of large shareholders pursue different strategies in relation to the board composition. While domestic and foreign investors rely on board independence, controlling family prefer to structure a less independent board. The finding suggests that the battle for corporate control different types of large shareholder begins with board structure.

The study contributes to the governance literature in several ways. First, the study investigates the representation of independent directors and the leadership structure in Indonesia. Although this country adopts a two-tier system, the study argues that the board leadership structure is of concern as the board combined leadership, to some extent, exists in Indonesia. Second, the study disentangles the impact of different types of large shareholders on board composition. Third, the study directly takes into account the effect of agency problem and various types of shareholders on board structure simultaneously.

The remainder of the paper is organized as follow. Section 2 develops hypothesis. Section 3 discusses research method. The following section presents hypotheses testing and the last section concludes and discusses the results of the study.

2 Theoretical background and hypotheses development

The standard view of agency theory posits that the boards would effectively perform their monitoring role whenever they are independent of management, where such an independent is attributable to the representation of independent directors and separated leadership structure (Dalton et al. 1998). Raheeja (2003) argues that outsider and insider directors have different properties. Specifically, outsider directors represent independence of management while insiders are well informed although they are lack of independence of management. Independent incorporates an unconstrained property that enables the board to exercise objective judgment of managerial performance and enhances the market mechanism for low-cost transfer of control (Fama 1980)¹. This view implies that the monitoring role is best performed by outside directors, where the higher representation of outside directors and the appointment of outside directors serving as board chairperson are claimed as encouraging the separation between management and control decisions.

The issue of board independence in a two-tier regime is related to the proportion of independent directors serving in the board while in a one-tier system board independence is associated with the representation of outside directors and the structure of board leadership. However, Prabowo and Simpson (2009) argue that the family members of controlling owners serving on the boards have identical properties to insider directors. Consequently, when the controlling family appoints their family members to serve as chairperson of the board, the outcome may be the type of combined leadership problem advanced by Jensen (1993). This argument implies that combined leadership, to some extent, is also prevalent empirically in a two-tier regime, whenever the controlling owner appoints their family members to serve as board chairperson. Therefore studying board composition in Indonesia should account for the board leadership structure as Claessens et al. (2000) claim that the existence of family control in Indonesia is a norm rather than exception.

The board of directors has been claimed as an internal institution primarily responsible for monitoring management (Fama, 1990). Jensen (1993) posits that the presence of a board of directors is a market induced mechanism representing production factors, although it is almost impossible to expect that this representation is naturally shown up in the board. Consequently, a firm may choose a certain governance configuration across the mechanism or within the mechanism that most effectively meets its organizational and environmental context (Du & Dei 2002)². This view implies that the board and its compositions are endogenously determined by internal and external factors specific to the firm, where the cost and benefit of particular board compositions are specific to the firm and the board compositions reflect the trade-off between cost and benefit for that particular firm. The specific factors have been claimed as being attributable to the presence of agency problem (Boone et al. 2007), interdependence among governance mechanism (Rediker & Seth 1995), and the distribution of corporate control (Yeh & Woidtke 2005).

¹ See also Clarke (2007) for further discussion on the concept of directors independence.

² The work of Heinrich (1999) provides a rationale for the coexistence of different configurations of corporate governance, as the consequence of the multitude of agency problems, that may produce equal outcomes. However, specific combinations of instruments "...which reinforce each other in minimizing agency costs fit together better than alternative combinations" (Heinrich 1999, p.2). In support of this notion, Danielson and Karpoff (1998) find that governance mechanisms vary across firms without any uniform pattern, suggesting that firms adopt certain governance combinations that best address their specific issues.

Theoretically, the level of agency problem is reflected in an inverse relationship with organizational outcome, where such a problem would be alleviated by the presence of governance mechanisms. This line of reasoning implies that firm performance is endogenously determined by governance mechanisms adopted by the firms. However, firms might improve particular governance mechanisms in response to poor prior firm performance although, in reverse, the governance improvement might enhance firm performance (Börsch-Supan & Köke 2002). Consistent with this notion, Hermalin and Weisbach (1998) posit that the probability of independent directors being added to the board rises following poor firm performance. They argue that governance mechanisms merely serve as a response to the prior poor performance in order to convince the market that the firms have adopted new strategies to overcome such performance problems.

In a broader perspective, the choice of governance portfolio is also related to the optimal differences suggesting that firms may endogenously and optimally choose different governance practices that best suit their specific challenge (Demzets & Lenh 1985). Accordingly, more profitable firms may choose a weaker governance as they have less need for outside capital (Black, Jang & Kim 2004). Conversely, a particular governance improvement depends on the resources available to the firm suggesting that better prior performance is associated with better corporate governance (Nowland 2008). Although producing conflicting result, these studies indicate the existence of the association between prior performance and the existing board composition. Therefore, it is predicted that prior performance is associated with the proportion of independent directors and board independent leadership. The formal hypotheses are:

- a: H₁ Prior firm performance is associated with the proportion of independent directors serving on the board.
- b: H₁ Prior firm performance is associated with board leadership structure.

Within agency theory, the identity of large shareholders has been claimed as being an important dimension of ownership structure as higher ownership by different types of shareholders has been argued as producing a different impact on the association between corporate control and organizational outcome. In the work of Lins (2002) the term 'large shareholder' refers to the family ownership that is prevalent in Asia, European, and Latin America. Previous studies have documented that ownership concentration is significantly related to the private benefit of control in East Asia (Claessens et al. 2002) and in developed countries (Gadhoun 2000; Ehrhardt & Nowak 2003) whenever such concentration is held by family. Morck and Yeung (2003) suggest that control by family serves as a device in pursuing the family interest that is not shared with the other shareholder. As the private benefit of control is associated with weak governance configuration, these findings implies that the higher family-controlled firm tend to have a less independent board.

Morck and Steier (2007) posit that elites are self-interest and cooperate to entrench themselves, even at considerable cost. They further advance *conservative bias* argument which suggests that the controlling owners prefer to *lock-in status quo control* and resist institutional reforms that might risk their current wealth. Therefore majority owners are more likely to oppose the board reform as it threatens their interest by surrendering certain degree of control to minority investors. Such a notion is confirmed by a study revealing that an insider-dominated board is associated with controlling owner's shareholding, which indicates that majority owners pursue the entrenchment strategy to reduce the board monitoring role in order to retain their control of the firm (Yeh & Woidtke 2005). Accordingly it is expected that controlling owners will prefer to maintain a less independent board. Thus, its is predicted that

- a: H₂ The fraction of independent directors is inversely related to the shareholding by controlling owners
- b: H₂ The independent leadership inversely related to the shareholding by controlling owners

In the work of Jiambalvo, Rajgopal and Venkatachalam (2002), the term 'large owner' refers to institutional shareholders either domestic or foreign. Domestic institutional shareholders has been claimed as enhancing board independence of management particularly when the market is illiquid due to the ownership concentration of listed firms (Erickson et al. 2005). This view is based on the assumption that market illiquidity makes exist strategy is difficult and is potentially harmful. Consequently, the only feasible strategy is voice, which require a channel to ensure that the strategy work well. Thus, institutional

investor would demand for the director's representation in order to enable them to vote against management decision. Foreign shareholders are believed to bring about improvement in corporate governance of host firms, since investing firms will demand such improvement to secure their investment (La Porta et al. 2000). This line of reasoning is grounded on the premise that developed countries like the US provide strong investor protection through various regulations and market mechanisms which, in turn, force firms to adopt sound corporate governance practices (Doidge 2004). Such a protection facilitates continuous scrutiny by shareholders (Doidge, Karolyi & Stulz 2004) and, thus, investing firms face performance pressure from their country of origin to ensure that they monitor their foreign investment (Boardman, Shapiro & Vining 1997).

Nevertheless, domestic and foreign investors have a similar bottom line in that they will demand for better governance. This view implies that the presence of institutional shareholders is related to higher board independence. Therefore, it is predicted that institutional ownership either domestic or foreign is associated with the proportion of independent directors and board independent leadership. Accordingly we predict that

- a: H₃ Domestic institutional shareholding is associated with the proportion of independent directors
- b: H₃ Domestic institutional shareholding is associated with board independent leadership.
- c: H₃ Foreign institutional shareholding is associated with the proportion of independent directors.
- d: H₃ Foreign institutional shareholding is associated with board independent leadership.

3 Research method

Following Claessen et al. (2002) and Claessens, Djankov and Lang (2000), the study uses various data sources namely: Annual Report (AR), Indonesian Capital Market Directory (ICMD), Profile of Publicly Listed Company (PPLC), Prominent (PRO), and Jakarta Stock Exchange (JSXL) list of independent directors (Table 1). Performance indicator is obtained from ICMD manual database. The controlling owner is identified through, firstly, referring to the AR that discloses the immediate owners. The next step is to trace the immediate owners to the PPLC that reports the business group of the ultimate owners. Following the work of La Porta et al. (1999), it is argued 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 in order to identify the independent directors.

Table 1. Operational definition and data source of variables

Variables	Acronym	Operational Definition	Source
Independent directors representation	IDPD	The proportion of independent directors serving on the board to total number of directors	AR, PPLC, PRO, JSXL
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
Controlling family ownership	FMLY	The proportion of shares owned by controlling family through the immediate shareholding to total outstanding shares.	AR, PPPLC, PRO
Foreign blockholder ownership	FRGN	The proportion of common share held by unrelated foreign blockholder to total outstanding shares.	AR
Domestic blockholder ownership	DOMT	The proportion of common share held by unrelated domestic blockholder to total outstanding shares.	AR
Assets	ASST	Natural log of asset	ICMD

The sample is based on all industrial firms that were listed in Indonesian Stock Exchange (IDX) for the period of 2006 to 2010, excluding banking and financial services firms as these industries are more likely to have a specific accounting standard (Lemmon & Lins, 2003) and the firms that were not presented in all data sources. This procedure leaves a final sample comprising 606 firm-year observations representing 30 industries that mostly engaged in manufacturing (72%). The remaining 28% are engaged in wholesale and trade, property, transportation service, communication, hotel and service, and holding companies. Machinery industry is absent from the final sample. However, this industry consists of only 0.3% of initial sample and thus it is expected that the exclusion is insignificantly affects the sample representation.

The analyses of the relationship between board structure and its determinant are based on the following models. The models include assets as control variables that the level of decision complexity (Daily & Dalton 1993) that lead to potential information asymmetry and accordingly the level of agency conflict.

$$\text{LEAD}_{it} = \alpha + \beta_1 \text{PERF}_{it} + \beta_2 \text{FMLY}_{it} + \beta_3 \text{FRGN}_{it} + \beta_4 \text{DOMT}_{it} + \beta_5 \text{IDPD}_{it} + \beta_6 \text{ASST}_{it} + \varepsilon_{it} \quad (1)$$

$$\text{IDPD}_{it} = \alpha + \beta_1 \text{PERF}_{it} + \beta_2 \text{FMLY}_{it} + \beta_3 \text{FRGN}_{it} + \beta_4 \text{DOMT}_{it} + \beta_5 \text{ASST}_{it} + \varepsilon_{it} \quad (2)$$

where:

- LEAD_{it}: leadership structure of firms i at year t
- IDPD_{it}: the fraction of independent directors of firm i at year t
- PERF_{it-1}: Return on Asset of firm i at year t-1
- FMLY_{it}: controlling family ownership firm i at year t
- FRGN_{it}: foreign blockholders ownership of firm i at year t
- DOMT_{it}: domestic blockholders ownership of firm i at year t
- ASST_{it}: natural log of assets of firm i at year t

The study relies 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)"³. This definition is consistent with Lukviarman (2004) claiming that the concept of "directors' affiliation" in Indonesian setting should refer to the controlling owners. The fraction of independent directors is defined as the ratio of independent directors serving on the board to total numbers of directors. 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.

Firm performance is measured using Return on Assets because market-based indicator is inappropriate in emerging countries where illiquid and thin trading market dictates the absence of efficient form of capital market (Joh, 2003). Return on asset is defined as the ratio of earnings before interest, extraordinary item, and taxes to total asset as of 2001. The unit of analysis uses the family, instead of individual, and therefore the individual shareholding of family members of controlling owners is aggregated in order to construct controlling family ownership. Following Capital Market Law 1995 (article 1) the family affiliation is defined as a relationship by marriage and/or blood both to second degree vertically and horizontally. The study defines the controlling shareholders ownership by simply accumulating the cash-flow right of their immediate ownership, using a 20% shareholding as a cut-off in differentiating between dispersed firms and family-controlled firm⁴. Blockholder is defined as an institutional shareholder, without any with controlling family, with at least 5% shareholding of the firm.

³ See SE-03/PM/2000, Kep-315/BEJ/062000, and Kep-339/BEJ/07-2001 art C.2.

⁴ See for example La Porta et al. (1999) and Claessens, Djankov and Lang (2000). However, it should be noted that this cut-off point is best viewed as "researcher discretionary" as the theoretical work justifying this point is unavailable.

4 Results

4. a Descriptive statistics and univariate tests

Table 2 presents descriptive statistics and the correlation of variables. The correlation coefficient between leadership structures the shareholding of controlling family (FMLY) and the proportion of outside director (IDPD) is significantly negative suggesting that family-controlled firms have lower independent directors. Complementary, the correlation between FMLY and board leadership (LEAD) is positive indicating that family-controlled firms prefer to appoint the family member of controlling owner to serve as board chairperson. This finding is in contrast with Dahya and McConnel (2005) documenting that UK firms with higher number of insider directors tend to adopt independent leadership in order to maintain board independence. Thus, Indonesian listed firm seems less likely to compensate the presence of higher number of insider directors with independent board leadership. Consequently, this board composition enables management to effectively control the board as the affiliated directors dominate the board and at the same time hold board chairperson position.

In contrast, the shareholding of foreign investor (FRGN) is positively related to the fraction of independent directors. Thus, the higher proportion of independent directors would be observed in the firms with foreign ownership. However, foreign ownership is insignificantly related to leadership structure. Taken together, the findings reveal that foreign investors prefer to rely on the presence of independent directors to monitor management. This figure is consistent with Alpay et al. (2005), providing empirical confirmation regarding the active participation of foreign investor in governance mechanism. Using data from Turkey, they found that firm with foreign investment have more independent, more experienced, and less insider dominated board. Overall, the correlations shows that leadership structure is associated with the type of large shareholders and therefore and shed a new light that the battle for corporate control between foreign and family begins with the choice of board structure.

Table 2. Descriptive statistics and correlations

	PERF	FMLY	FRGN	DOMT	IDPD	ASST	LEAD
Mean	3.549	40.186	24.606	5.635	36.292	11.946	2.393
Median	2.850	49.605	10.110	0.000	33.330	11.894	2.000
Max	147.82	99.120	99.740	90.020	100.000	14.053	3.000
Min	112.48	0.000	0.000	0.000	0.000	8.955	1.000
PERF	1						
FMLY	-0.077	1					
FRGN	0.113^a	-0.752^a	1				
DOMT	0.018	-0.367^a	-0.015	1			
IDPD	0.051	-0.253^a	0.115^a	0.275	1		
ASST	0.185^a	-0.061	0.053	0.029	0.142 ^a	1	
LEAD	0.013	0.559^a	-0.335	-0.328	-0.222	-0.066 ^a	1

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

4. b Multivariate

The study hypothesizes that the level of board independence, measured by the representation of independent directors and the structure of board leadership, is related to prior firm performance, ownership structure, and firm size. Table 3 reports the results from OLS regressions linking the representation of independent directors, prior firm performance, ownership structure, and firm size. The F-values for all specification is significantly high and the R² is ranging between 106 and 0.118.

Table 3: OLS Regression of the Proportion of Outside Directors on Prior Firm Performance, Ownership Structure, and Firm Size. The specifications are based on model (1). ^a, ^b and ^c represent significance at the 1%, 5%, and 10% level respectively. Variables definitions are given in Table 1.

		1	2
Constant	Beta	0.234	5.449
	t-value	0.024	0.550
ROA _{it-1}	Beta	0.008	0.009
	t-value	0.215	0.248
FMLY _{it}	Beta	-	-0.078^a
	t-value	-	-4.016
FRGN _{it}	Beta	0.051^a	-
	t-value	2.812	-
DOMT _{it}	Beta	0.257^a	0.198^a
	t-value	7.054	5.098
ASST _{it}	Beta	2.806^a	2.763^a
	t-value	3.374	3.345
R ²		0.106	0.118
Adj R ²		0.100	0.112
F		17.829 ^a	20.098 ^a
Sig		0.000	0.000

Specification 1 reveals that the proportion of independent directors serving on the board is positively related to foreign ownership suggesting that foreign ownership to count on independent directors to ensure that their interests is well respected. Similarly the proportion of independent directors serving on the board is related to the level of shareholding by domestic unrelated blockholders at 1% significance level. The positive sign suggests that the presence of independent directors is more likely to exist with the existence of domestic institutional investors. Prior firm performance (ROA_{t-1}) is insignificantly related to the proportion of outside directors indicating that such a proportion is independent of prior firm performance. The finding reveals that the proportion of independent directors is exogenous variable of prior organizational outcome. Firm size is found to have positive significant relationship with dependent variable confirming that board composition, as a monitoring device, is driven by the complexity of firms operation.

Specification 2 shows the proportion of independent directors serving on the board is related to controlling family ownership at 1% significance level. The negative sign indicates that a family-controlled firm is more likely to have less independent board. The relationship between unrelated domestic blockholding and the proportion of independent directors serving on the board persist at 1% significance level. The insignificant relationship between the prior performance and the proportion of independent directors remain unchanged. The same hold true for firm size.

Table 4 reports the results from OLS regressions linking board leadership structure, firm performance, ownership structure, the representation of independent directors, and firm size. The F-value for all specification is significant at the 1% level and the R² is ranging between 0.218 and 0.248. Specification 1 reveals that the level of foreign shareholding is related to the board leadership structure at 1% significance level.

The negative sign suggests that the presence of independent directors serving as board chairperson would be observed in the presence of higher foreign shareholding. A similar result holds for the relationship between domestic unrelated blockholders and leadership structure. Taken together, these findings imply that a more independent board would be observed in the firm with foreign and unrelated domestic blockholders. The proportion of independent directors is found to have a negative relationship with leadership structure indicating that an outsider-dominated board is more likely to have independent directors serving as the board chairperson. Prior firm performance and assets are insignificantly related to board leadership structure at conservative level ($p > 5\%$), confirming that board independence is unrelated to the level of agency problem.

Specification 2 shows that controlling family ownership is positively related to the board leadership structure at 1% significance level, suggesting that family-controlled firms tend to have either affiliated director or a family member of controlling owners serving as board chairperson. The significant relationship between unrelated domestic blockholder and independent leadership persists even in the presence of family ownership. However, the effect of independent directors on leadership structure becomes insignificant ($p > 5\%$) with the presence of family ownership. This findings reveals that

independent directors representing outside shareholder lose their power to stand before controlling family. In other words, controlling family is able to dominate the board room in structuring board leadership.

Table 4: OLS Regression of the Leadership Structure on Prior Firm Performance, Ownership Structure, the Proportion of Outside Directors, and Firm Size. The specifications are based on model (2). ^a, ^b and ^c represent significance at the 1%, 5%, and 10% level respectively. Variables definitions are given in Table 1.

		1	2
Constant	Beta	3.162 ^a	2.482 ^a
	t-value	7.935	6.636
ROA01	Beta	0.003	0.003
	t-value	1.879	1.883
FMLY	Beta	-	0.010^a
	t-value	-	13.653
FRGN	beta	-0.007^a	-
	t-value	-9.134	-
DOMT	beta	-0.013^a	-0.005^a
	t-value	-8.240	-3.550
IDPD	beta	-0.004^a	-0.003
	t-value	-2.591	-1.663
ASST	beta	-0.033	-0.032
	t-value	-0.970	-1.019
R ²		0.234	0.334
Adj R ²		0.227	0.328
F		36.590 ^a	60.182 ^a
Sig		0.000	0.000

5 Conclusions, discussions, and limitations

The study investigates the effect of ownership structure and the level of agency problem on the structure of board of directors in Indonesia. Using a dataset consisting of 606 firm-year observations during the period of 2006 to 2010, the study finds that ownership in Indonesia is concentrated in the hand of few wealthy families where the presence of unrelated institutional shareholders is only prevalence in a small portion of the sample. The analyses reveal systematic evidence that the proportion of independent directors is endogenously determined by the shareholding of controlling family, foreign ownership, and domestic institutional shareholders and. In other side, controlling family ownership is related to board affiliated leadership while foreign ownership and unrelated domestic blockholder is more likely to have board independent chairperson. Outsider dominated board is more likely to have board independent leadership. Taken together, the findings provide interesting remarks. First, unrelated domestic blockholder seem to pursue strategy similar to foreign investors in monitoring management. Both types of investors rely on the representation of outside directors and board leadership. Second, the battle for corporate control the family, in one side, and unrelated domestics and foreign investors, on the other side, begins with board independence. Particularly, controlling family is more likely to structure less independent board while, in the contrary, foreign and domestic investors tend to prefer a more independent board. As such, the type of large shareholders does matter in the choice of control devices. That is different owners pursue different strategies in an attempt to mitigate potential expropriation and thereby securing their investments. In the case of independent directors representation in Indonesia, the results indicate that the production factors might not be naturally shown up in the board structure unless specific regulations are in place.

Prior firm performance is insignificantly related to the representation of independent directors serving on the board. In contrast, firm size has positive relationship with board composition. Larger firm tend to choose more independent directors serving at the board of directors. Firm performance has been quoted as being an inverse function of the agency conflict between principal and agents (Jensen & Meckling, 1976) while the size of the firm represents complexity of firm's operation (Daily & Dalton, 1993) that potentially lead to the level of information asymmetry. Based on this line of reasoning, accordingly, the findings suggest that board structure is more likely to be related to the complexity of firms operation.

Several caveats are in order. First, the study leaves the property of board unaddressed. The failure to adequately control for the backgrounds of the independent directors (Erickson et al., 2005), the involvement of independent directors in board committees (Cotter & Silvester, 2003), and the nomination and appointment process (Rosenstein & Wyatt, 1990; 1997) has been quoted as potentially confounding the results and its interpretation. Another shortcoming is in regard to the measure of controlling family ownership that relies on their immediate shareholding via their intermediate companies. This procedure leads to the absence of separation between voting rights and cash flow rights, and accordingly this study fails to disaggregate entrenchment effect and alignment incentive effect. Although there is significant incidence of governance research aggregating such effects (see for example Guriev et al. (2003), Welch (2003) and Klasa (2002)), it might have different impacts on the choice of internal governance mechanisms. Finally, the study uses accounting numbers to define performance indicator as they have been independently verified by external auditors. However, accounting-based indicators might suffer from earnings management and thereby distorting financial statements that benefit one contracting parties at the expense of others (Chung, Firth & Kim, 2004). Thus, the adoption of accounting-based indicators might prevent this study to generalize its finding. Further research that eliminates those shortcomings would be worth of governance literature in relation to the board structure in Indonesia

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