

BOARD QUALITY AND THE PERFORMANCE OF INDONESIAN LISTED COMPANIES

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Abstract

This paper provides an analysis on the effect of board quality on company performance. Using a sample of 133 companies listed on the Jakarta Stock Exchange in the year 2007, this study specifically examines whether *multiple directorships*, *director shareholding* and *board independence* (i.e. proxies for board quality) can be associated with company financial performance. This study also investigates the effect of audit committee characteristics (as proxied by *audit committee independence* and *financial expertise*) on company performance, while controlling for the effects of *leverage* and *size*.

With regard to board quality, the results indicate that only *board independence* is found to be associated with performance, though in the opposite direction. The direction of influence suggests that having too many independent directors (i.e. non-executive) might slow down the business as they might have a lack of detailed knowledge about the company's business, and are more concerned about their gatekeeper role. As expected, *leverage* and *size* are found to have a significant influence on company performance.

Keywords: Sarbanes-Oxley Act, Corporate Governance, Indonesia, Performance, Board Quality

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Introduction

Since Berle and Means (1932), corporate governance has developed to be one of the most important aspects of today's corporations. In Asia, the issue of corporate governance has intensively been debated, especially after the late 1990's Asian Financial Crisis. The same has also been debated in Indonesia, where the financial crisis inevitable turned into a political crisis. More recently, the role and responsibilities of the board have been highlighted by regulators and academics around the world, in particular after the downfall of Enron, WorldCom and several other corporations in the US. In response to those high-profile collapses, the US government passed the Sarbanes-Oxley Act in 2002, which subsequently prompted many countries to promulgate a new corporate governance code. In Indonesia, the code was revised from the 2001 version and then re-issued in 2006.

Over time, the number of Indonesian's listed companies has been growing rapidly. For instance, in 2000, the number of listed companies in Indonesia was only 347 and in 2007, the number increased to 468. These changes account for 35% of growth since 2000 with a 4.3% growth rate per annum. In line with the increasing number of companies seeking capital from the public through the Jakarta Stock Exchange, the government has introduced several measures to ensure good practice of governance. Despite the steady growth in the numbers of listed companies, however, the performance of these companies has fluctuated over time. It is reported that in 2005, 17% of the listed companies experienced negative return on assets (ROA). Despite the percentage decreasing to 15% in 2006; the number was still considerably large (Ilona, 2008).

Poor company performance is believed to be caused by many factors. According to Porter (1991), the company's strategy and its implementation are the factors affecting company performance. It is also suggested that another factor that contributes to the companies' performance is corporate governance. The

response of corporate governance in Indonesia has been shown through the issuance of the Code of Corporate Governance. Indonesia's Corporate Governance Committee issued the Code in 2001 and in 2006, released a revised version. As mentioned by the Chairman of the National Committee on Governance, Mr. Achmad Nadiri, the code is expected to become 'a meaningful contribution' for economic recovery in Indonesia. Amongst the objectives of the code are: (i) to achieve sustainable growth of a company through a management system, and (ii) to enhance the competitiveness of a company, both nationally and internationally.

Several studies have investigated the effect of corporate governance on company performance (e.g., Vafeas and Theodorou, 1998; Hossain et al., 2001; Callahan et al., 2002; Peng et al., 2003; Haniffa & Hudaib, 2006; Bennedson et al., 2007). However, the findings of these studies, generally, are inconsistent. These include the studies that have been undertaken in Indonesia (e.g. Suaryana, 2005; Pudjiastuti & Mardiyah, 2007). However, it is important to note that, in general, Indonesian studies on the effects of corporate governance and company performance are still limited. In fact, since the revision of the Code of Corporate Governance has been released in 2006, to our knowledge, there are no Indonesian studies that have been undertaken to investigate the relationship between board structure and company performance. Hence, the present study aims to investigate the effect of the board quality on the company performance post- 2006. This study is expected to contribute towards a better understanding of agency theory.

Using a sample of 133 companies listed on the Jakarta Stock Exchange in 2007, the results indicate that only *board independence* is associated with performance, though in the opposite direction. The direction of influence might suggest that having too many independent directors (i.e. non-executive) might slow down the business as they might have less detailed knowledge about the company's business, and are more concerned about their gatekeeping role. Consistent with prior studies, *leverage* and *size* are also found to be significant factors in determining company performance.

The remainder of this paper is organized as follows. The next section discusses related literature and outlines the research hypotheses. It is followed by a description of the data and methods. Then, the following section reports the results of the empirical analysis. The final section concludes the paper and offers some recommendations for future research.

Prior studies and hypotheses development

Agency theory assumes that there is a conflict of interest between principal and agent. It argues that the agent is motivated to pursue their own goals, rather than to increase the principal's wealth. According to the asymmetric information hypothesis, this conflict exists because the agent has access to more information than the principal. In order to reduce this agency conflict, the principal has to control the behavior of the agent through good corporate governance (Jensen & Meckling, 1976). This agency theory serves to underpin the relationship between corporate governance and company performance, including the role of the board of directors to improve a company's performance. The present study establishes the relationship between agency variables and performance by employing an agency theory perspective. Those agency variables include *multiple directorships*, *director shareholding*, *board independence*, *audit committee independence* and *audit committee financial expertise*.

Multiple Directorships

Fama (1980) and Fama & Jensen (1983) argue that *multiple directorships* may be valuable to companies. It has been argued that the directors who serve on multiple boards have broader experience, and network and commercial contacts (Mace, 1986). They are capable of providing profound advice and offer better monitoring. From a resource-based and resource-dependent perspective, directors with multiple directorships can be perceived as more intellectual, reputational and having better networking resources. These in turn will facilitate access to financial and human capital resources, provide timely advice and counsel when needed and make the decision process insightful (Van den Heuvel et al., 2006). Arguably, these directors will have more valuable director capabilities than directors with a single directorship. They have a higher potential for service effectiveness and thus can have positive effects on company performance. Therefore, the following hypothesis is proposed:

H₁: There is a significant relationship between multiple directorships and company performance.

Board of Commissioner Shareholding

Jensen & Meckling (1976) state that the extent of managers' shareholdings can reduce agency costs as it serves to align the interests of the management with those of other shareholders. To do so, it is suggested that management should be compensated with ownership (Jensen & Meckling 1976). With board ownership, it reduces the opportunistic behavior and therefore reduces the agency cost, and consequently will increase company performance. This argument is supported by several prior studies that report significant (albeit weak) relationships between directors' shareholdings and company performance (e.g., Craswell et al., 1997; Vafeas & Theodorou, 1998; Haniffa & Hudaib, 2006). Following that, the second hypothesis is proposed as follows:

H₂: There is a significant relationship between the directors' shareholding and company performance

Board Independence

Boards of commissioners are regarded as one of the most important control and monitoring mechanisms, especially in financial reporting. Members of the board can be categorized into two types, namely: executive and non-executive directors (Bennedson et al., 2007). An executive director is generally a full-time employee, and a senior executive of the company who has responsibility in the day-to-day operations. They have direct responsibility for aspects of the business such as finance and marketing. They also help to formulate and implement corporate strategy. On the other hand, a non-executive director is appointed from outside. Non-executive directors are outside directors who monitor the decisions made by the executive directors. Non-executive directors are part-time and executive directors are full-time employees of the company. The empirical findings suggest that there is a relationship between the proportion of board membership (independent vs. non-independent) on the comprehensiveness of financial disclosure (Dehaene et al., 2001; Hossain et al., 2001; Haniffa & Hudaib, 2006; Bennedson et al., 2007; Lefort & Urzua, 2008). Given the significant role of non-executive directors in monitoring the executive directors, the third hypothesis is proposed as follows:

H₃: There is a significant relationship between outside board independence and company performance

Audit Committee Independence

The role of audit committees is to ensure high quality financial reporting. Hence, an effective audit committee should have independent behavior. Spira (1999) argues that there are two aspects of independence. The first relates to a personal quality found in a particular individual (equivalent to independence in fact) and the second represents a notion of distance and detachment that is assumed to be essential to objective judgment (equivalent to independence in appearance).

Hsu (2007) found no association between audit committee independence and company value. Klein (2002) concluded that there is a negative relationship between independent audit committee and earnings management. Other scholars (e.g., Anderson et al., 2004; Erickson et al., 2005; Chan & Li, 2008) find that there is a positive relationship between the audit committee independence and company performance. Thus, the fourth hypothesis is developed as follows:

H₄: There is a significant relationship between audit committee independence and company performance.

Audit Committee Financial Expertise

To effectively monitor and control managerial actions, especially the ones that relate to financial reporting, it is expected that the audit committee should possess some degree of financial expertise. Financial knowledge can help audit committees to perform their tasks, such as detecting material misstatements or assessing risky projects, more effectively. Financial expertise can be gained by audit committee members through employment or experience in either accounting or finance, or professional certification in accounting or finance.

Zhang et al. (2007) suggests that there is a relationship between audit committee quality (financial expertise) and internal control weaknesses. DeFond et al. (2005) found a significant relationship between audit committee accounting/financial expertise and the improvement of corporate governance. Other

researchers found a positive association between audit committee financial expertise and company performance (e.g., Al-Mudhaki & Joshi, 2004; Hsu, 2007; Chan & Li, 2008; Guner et al., 2008; Jiang, 2008). Based on prior findings, the following hypothesis is proposed:

H₅: There is a significant relationship between audit committee financial expertise and company performance.

Research methods

Sample Selection

The sample for the present study was selected from a list of companies listed on the Indonesian Stock Exchange (formerly known as the Jakarta Stock Exchange). As of 31 December, 2007, 468 companies were listed on the Exchange. However, of the 468 companies, forty-four were newly-listed companies and hence the first annual reports were not available for the financial year end for 2007 and were thus discarded. At the time of the data collection (i.e. August 2008), 291 companies had yet to submit their annual reports to the Exchange. This resulted in only 133 companies being included in the study.

Variables Measurement

The description of variables can be found in Table 1. The dependent variable, i.e. company performance, is measured using the ratio of return on assets (*roa*). In particular, it is measured as the earnings before tax divided by total assets of the companies.

There are eight independent variables. The board quality variables, which are governance-related variables, are proxied by multiple directorships (*multi_dir*), director's shareholding (*bod_own*), board independence (*bod_ind*), audit committee independence (*ac_ind*) and audit committee financial expertise (*ac_expert*).

Table 1. Variable Description

Variables	Code	Description
Company performance	<i>roa</i>	A proxy for company performance, as measured by return on assets (ROA)
Board quality	<i>multi_dir</i>	A proxy for board quality as measured by the percentage of commissioners who have multiple directorships
Board shareholding	<i>bod_own</i>	A proxy for board quality as measured by the amount of directors' shareholding to the total of shareholders
Board independence	<i>bod_ind</i>	A proxy for board quality (board independence) as measured by the percentage of outside commissioners relative to the total directors on the board
Audit committee independence	<i>ac_ind</i>	A proxy for board quality (audit committee independence) as measured by the proportion of the independent directors on the audit committee
Audit committee financial expertise	<i>ac_expert</i>	Audit committee financial expertise is measured by the proportion of the financial experts (experience in accounting) on the audit committee
Company size	<i>ln_size</i>	Natural log of company total assets
Company fixed assets to total assets	<i>fata</i>	Fixed assets to total assets
Leverage	<i>lev</i>	Total debt to total assets

Studies that utilize multiple directorships as a proxy for the quality of the board include Kiel & Niclason, (2006) and Sarkar & Sarkar (2008). The variable is measured as the percentage of commissioners who have interlocked relationships (i.e. also director in other companies).

Meanwhile, Board of Commissioner shareholding is measured by the number of the directors' shareholding in the companies as suggested by Craswell, Taylor et al., 1997; Vafeas & Theodorou, 1998; and Haniffa & Hudaib, 2006. It is measured as the ratio of directors' shareholding to total shares outstanding.

Board independence is proxied by the ratio of outside commissioners to the total number of commissioners on the board. This measure has been employed by many researchers, such as Dehaene et al., (2001), Peng et al., (2003), Pudjiastuti & Mardiyah (2007), and Lefort & Urzua (2008).

To be consistent with Anderson, Manasi, & Reeb (2004), Erickson et al., (2005), Hsu (2007) and Chan and Li (2008), audit committee independence is measured as the proportion of the independent directors on the audit committee.

Audit committee financial expertise in this study is measured by using a measurement offered by many researchers (e.g. Al-Mudhaki & Joshi, 2004; Hsu, 2007; Chan & Li, 2008; Guner et al., 2008; Jiang, 2008). It is measured by seeing the proportion of the financial experts on the audit committee. Hence, the financial experts are categorized as personal work experience in accounting and finance.

To control for the effect of other variables on companies performance, three variables are also included in this study. The variables are: depreciable assets (*fata*), company size (*ln_size*) and leverage (*lev*). A depreciable asset is measured by the ratio of fixed assets to total asset (*fata*). Similar measure has been used by Hsu (2007). Meanwhile, the company size (*ln_size*) is measured by total assets (see for example: Hossain et al., 2001; Peng et al., 2003; Haniffa & Hudaib, 2006; Hsu, 2007; Pudjiastuti & Mardiyah, 2007). Finally, the leverage (*lev*) is measured by the ratio of total debts to total assets (see for example: Craswell et. al., 1997; Hossain et. al., 2001; Haniffa & Hudaib, 2006; Hsu, 2007).

Model

To estimate the effect of corporate governance variables on company performance, the present study utilized the Ordinary Least Square analysis. The following regression model was estimated:

$$roa = \beta_0 + \beta_1 multi_dir + \beta_2 bod_own + \beta_3 ac_ind + \beta_4 ac_ind + \beta_5 ac_expert + \beta_6 ln_size + \beta_7 fata + \beta_8 lev + \varepsilon$$

Results

Multivariate Analysis

To clean the data from classical assumption problems, several tests are used. Outliers are identified by using Grubb's extreme Studentised deviation test. It is based on the standard normal z-statistic:

$$Z = \frac{\text{mean} - \text{value}}{\text{SD}}$$

The mean and the standard deviation were calculated using all of the values. Therefore, the Z value is compared to a critical Z value. The null hypothesis was rejected if the computed Z value is greater than the critical Z value and that value is identified as an outlier (Barnett & Lewis, 1994). Once an outlier was identified, the value of that outlier is replaced to the next highest value. Grubb's test can only detect one outlier at a time; the procedure needs to be repeated until no further outliers are detected.

Multi-collinearity is used to check whether there is any relation among the independent variables. It uses two tests to ascertain whether there is any multi-collinearity problem, namely, the Pearson correlation and the Variance Inflation Factor (VIF). This can be seen in Table 2. If the result of the Pearson correlation is higher than 0.6, it means there is a relation among the independent variables (Anderson et al., 1996). However, the results indicate that the Pearson correlation is lower than 0.7. It can be concluded that there is no multi-collinearity problem.

Table 2. Result of Pearson correlation

	1	2	3	4	5	6	7	8	9
Roa	1.00								
multi_dir	0.07	1.00							
bod_own	-0.00	0.10	1.00						
bod_ind	-0.17	-0.21*	-0.01	1.00					
ac_ind	-0.11	-0.18*	-0.00	0.04	1.00				
ac_expert	-0.03	-0.05	-0.08	0.15	0.19*	1.00			
fata	0.00	0.12	0.16	-0.19*	0.03	-0.06	1.00		
lev	-0.40**	-0.10	-0.08	0.07	0.19*	0.05	-0.05	1.00	
ln_size	0.20*	-0.08	-0.12	0.13	0.27**	0.15	-0.09	0.08	1.00

Notes: Two-tailed, bold = significant at 5% level

The Pearson's result is also supported by the Variance Inflation Factor (VIF). VIF was used by many researchers to detect multi-collinearity problems (Gujarati, 1995). The border of tolerance value is 0.10, while the VIF border is 10 (Hair et. al., 1995). The result indicates that the VIF value for the two regression equations was below 10 and the tolerance value was 0.10. Thus, it can be concluded that there is no multi-collinearity. Furthermore, to test the autocorrelation, the Durbin-Watson method is used. The Durbin-Watson test (d) averaged 1.953, meaning that no serial correlations among the disturbance terms or the variables are independent.

The summary of the result of estimation on the influence of director quality on company performance can be seen in Table 3. F-statistic is 5.164 with a significance level of 0.000. This indicates that the model is far more fit due to the significance level being below 0.05. Therefore, this model can be interpreted with unbiased results (Gujarati, 1995). The second indicator of goodness of fit is based on adjusted R² due to it being more acceptable than R² (Gujarati, 1995). In addition, the adjusted R² indicates that 20% of the dependent variable (ROA) can be explained by the independent variables.

Table 3. Result of Regression of Board Quality and Company Performance

Variable	Coeff.	SE	t-value	p-value	VIF
Constant	0.01	0.04	0.29	0.77	
multi_dir	0.00	0.02	0.05	0.96	1.09
bod_own	0.03	1.35	0.02	0.98	1.05
bod_ind	-0.07	0.04	-2.13	0.04	1.11
ac_ind	-0.03	0.03	-1.06	0.29	1.18
ac_expert	-0.00	0.01	-0.16	0.87	1.07
Fata	-0.01	0.02	-0.27	0.79	1.08
Lev	-0.09	0.02	-4.91	0.00	1.05
ln_size	0.02	0.01	3.41	0.01	1.13

F stat = 5.164

P value = 0.000

R² = 0.250

Adjusted R² = 0.202

There are five hypotheses offered in this study. The statistical property used to see whether the hypotheses is accepted or rejected is for a P value ≤ 0.05 . Of all five proxies of board quality, only board independence was found to be significantly related to company performance. However, the coefficient sign shows an adverse relationship. The results suggest that company performance will deteriorate when the board consists of a high number of non-executive directors. The results of a study by Agrawal & Knoeber (1996) might possibly offer some insight on why non-executive directors have a negative rather

than a positive impact on corporate financial performance. Among the explanations offered was that independent directors were added to boards in already poorly performing companies in order to improve the performance. Hermalin & Weisbach (1998) also presented the same results. However, upon further tests, Agrawal & Knoeber (1996) find that it is actually the board that caused the performance rather than otherwise. They contend that there are possibilities that the boards are expanded for political reasons, for instance, by including politicians, environmental activists or consumer representatives. The inclusion of this group of personalities has limited or reduced company performance. As put forward by Solomon and Solomon (2005) '...too great a proportion of independent or non-independents can swing the balance in the wrong direction'. In addition, the same authors also argue whether or not non-executive directors who are alleged to be independent are truly independent. Mace (1986) and Vancil (1987) for example, question the independence of non-executive directors when the appointment process itself is affected unduly by cronyism.

Of the three control variables used in this study; only leverage and size were found to be significantly associated with performance. The result shows that there is a negative significant relationship between leverage and company performance. This finding is consistent with the studies of Craswell et al. (1997), Hossain et al. (2001), Haniffa & Hudaib (2006) and Hsu (2007). As for the size variable, the result indicates that there is a positive significant relationship between size and company performance. This result is consistent with the studies of Hossain et al. (2001), Hsu (2007) and Pudjiastuti & Mardiyah (2007).

Conclusions

The objective of this study is to empirically investigate if a single aspect of corporate governance, namely board quality, affects company performance in Indonesia. Based on a sample of 133 companies listed on the Jakarta Stock Exchange in 2007, the present study examines if *multiple directorships*, *director shareholding* and *board independence* (i.e. proxies for board quality) can be associated with company financial performance. This study also investigates the effect of audit committee characteristics (as proxied by *audit committee independence* and *financial expertise*) on company performance, while controlling for the effects of *leverage* and *size*.

With regard to board quality, the results indicate that only *board independence* can be associated with performance, though in the opposite direction. The direction of influence might suggest that having too many independent directors (i.e. non-executive) might slow down the business as they might have lack of detailed knowledge about the company's business, and are more concerned about their gatekeeping role. Consistent with prior studies, *leverage* and *size* are also found to be significant determinants.

Of its importance, the results of this study help to establish a starting point for exploring empirically the importance of corporate governance structure after the publication of the revised Code of Corporate Governance for Indonesia in 2006. However, due to its limitations, the results of the study should be interpreted with caution. Firstly, this study only utilized the data from one fiscal year. Studies done with multiple periods of data might provide different findings, and be statistically more robust. Secondly, there is also the limitation that relates to model specifications. Due to sample size constraints, the study did not include all potential determinant variables. This inevitably might cause specification bias. As suggested by prior studies, company performance could also be explained by other corporate governance variables or other management related variables. The inclusion of these variables might improve the estimation power of the model. By considering those limitations, it is expected that future research should consider adding more data as well as including other aspects of corporate governance variables, such as characteristics of remuneration and nominating committees.

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