

Directors' Ownership and Firm Performance in Indonesia

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Abstract

The purpose of this paper is to investigate the influence of directors' ownership on the financial performance of firms listed on the Indonesian Stock Exchange from 2008 to 2012. The method uses quantitative approach, namely multiple linear regression. The financial performance is measured with return on assets (ROA). The research shows that directors' ownership does not significantly influence firm performance. This implies that directors' ownership of listed firms in Indonesia is not proven to get the interests of directors and shareholders aligned. This paper is particularly important to the policymakers and shareholders of firms in Indonesia and other developing economies since it provides a comprehensive insight into the directors' ownership – firm performance relationship and therefore it helps them to formulate the best policies.

Keywords: ROA; directors' ownership; firm performance

Abstrak

Tujuan makalah ini adalah untuk meneliti pengaruh kepemilikan direktur terhadap kinerja keuangan perusahaan-perusahaan yang tercatat pada Bursa Efek Indonesia dari tahun 2008 hingga 2012. Metode yang digunakan adalah metode kuantitatif, yaitu regresi linier berganda. Kinerja keuangan diukur dengan return on assets (ROA). Hasil penelitian menunjukkan bahwa kepemilikan direktur perusahaan tercatat di Indonesia tidak berpengaruh signifikan terhadap kinerja keuangan perusahaan tersebut. Temuan ini menyiratkan kepemilikan direktur tidak terbukti dapat menyelaraskan kepentingan direktur dan para pemegang saham. Makalah ini terutama penting bagi para pengambil kebijakan dan pemegang saham pada perusahaan-perusahaan di Indonesia dan negara-negara berkembang lainnya karena menyediakan tinjauan yang komprehensif terhadap hubungan kepemilikan direktur dan kinerja keuangan, sehingga dapat membantu mereka dalam merumuskan kebijakan-kebijakan terbaik.

Kata kunci: ROA, kepemilikan direktur, kinerja perusahaan

A. INTRODUCTION

There are ample literatures that have discussed the effect or influence of directors' ownership on firm performance which are predominantly based on agency theory. While those literatures mainly deal with the context of developed economies, this paper examines the relationship between directors' ownership and financial performance of listed companies in Indonesia, one of developing economies in Asia.

The ownership of a modern corporation is usually separated with control. At the early 20th century, Berle and Means (1932) highlighted that the ownership and control of corporations became separated following the countries' industrialization and market development. Such separation is more prevalent in common-law countries (e.g. the United States and the United Kingdom) and less so in civil-law countries (e.g. Latin America countries) (Mallin, 2019).

Nevertheless, the ownership and control converge when they are in the hand of the same individuals. This is the case when directors own some portion of the shares of the company, he/she controls. In this regard, it is presumed that the actions taken by the directors would not reduce shareholder wealth regardless their independence degree (Booth et al., 2002).

According to Keasey et al. (1994), previous studies assume that when directors hold shares of a company they control, they and external shareholders hold similar value maximising objectives. However, it is also feared that the increased directors' ownership will give power to the directors to improve their own compensation and perquisites.

In terms of attitude towards risk, Keasey et al. (1994) argued that the risk aversion of a director depends on the existence of his/her directorship in other firms or his/her ownership level at a firm he/she controls. In other words, the directors will be less risk averse if they hold directorship in other firms.

Vance (1983) in Kesner (1987) suggested that stock ownership by directors has greater influence than the issue of inside/outside directors. With regard to outside directors, Peasnell et al. (2003) argued that the demand for monitoring mechanisms by outside directors is predicted to be reduced when there is managerial equity ownership due to its incentive-alignment effects.

According to modern portfolio theory, managers who own stocks in their firm should sell their shares to diversify away the unsystematic risk related with wealth concentration in a single asset. The risk of managerial ownership is higher than that of ordinary ownership because executives already have human capital value correlated with firm performance (Ofek & Yermack, 2000).

Actually, managerial equity ownership is one well known solution to prevent them from using corporate assets for their personal benefit rather than for maximising shareholder wealth (moral hazard problem) (Himmelberg et al, 1999). Nevertheless, when equity ownership by managers is too high, they will be insulated from external market discipline and this will create managerial entrenchment problems (McConnell & Servaes, 1990; Morck et al., 1988). Due to this contradictory effect of managerial equity ownership, I am interested to investigate how it influences firm performance in Indonesia. Therefore, the problem statement of this study is: does directors' ownership influence firm performance in Indonesia?

The objective of this study is to investigate the influence of directors' ownership on firm performance in Indonesia. The organization of this paper is structured as follows. Section 2 presents the literature review on directors' ownership. Section 3 describes the research methodology. Section 4 presents the summary of the findings, and Section 5 concludes.

B. LITERATURE REVIEW

Demsetz and Lehn (1985) suggested that greater uncertainty which includes instability of prices, technology, market shares, and so forth causes greater directors' ownership of a firm. In addition, they also argued that firm riskiness (measured by stock price volatility) determines directors' ownership. Himmelberg et al. (1999) believed that main variables in the contracting environment, namely firm size, scope for discretionary spending, managerial risk aversion (i.e. observable firm characteristics) influence managerial ownership in ways consistent with the predictions of principal-agent models. Furthermore, they also argued that directors' ownership becomes an optimal incentive arrangement of a firm if the ownership level is adjusted with the scope for perquisite consumption.

Scholars are split in their opinion on the relationship between directors' ownership and firm performance. On the one hand, Jensen and Meckling (1976) argued that increasing the fraction of shares owned by corporate insiders will cause the increase in firm value. This is in line with agency theory (Jensen & Meckling, 1976) which postulates that common stock ownership by managers (insider ownership) may reduce agency costs because it better aligns their interests with those of stockholders. Hill and Snell (1989) believed that when directors' hold significant portion of stocks of firms they direct, it is more likely that they make decisions consistent with stockholders' wealth maximisation due to the fact that they are also stockholders. Grossman and Hart (1986) argued that transaction costs are greater when managerial ownership is removed. This implies that managerial ownership has the potential to reduce agency conflicts and hence improve firm performance. Farrer and Ramsay (1998) also implied that directors' ownership is important in Australia. This can be seen in the minimum share ownership requirement for directors in some companies in that country, suggesting that the ownership can provide incentives to directors to maximise firm performance. Other scholars like Mehran (1995), Han and Suk (1998), Bhagat and Bolton (2008) and Kaserer and Moldenhauer (2008) also found the positive relationship between insider ownership and firm performance.

On the other hand, as also argued Farrer and Ramsay (1998), excessive directors' shareholding accompanied with the absence of their wealth diversification will not make the directors' interest aligned with those of outsider shareholders because the directors become more risk averse. This argument is also shared by Sundaramurthy et al. (2005) who argued that entrenchment effect appears when directors' ownership reaches certain level and this effect negatively influences firm performance. And more recently, Rashid (2016) found both the convergence of interest and entrenchment in his investigation on managerial ownership and agency cost among listed firms in Bangladesh.

C. RESEARCH METHOD

This study uses quantitative approach. Denzin and Lincoln (1994) in Sale et al. (2002) stated that the quantitative approach is used to measure and analyse causal relationship between variables within a value-free framework. The research method used is the statistical associative method as it is intended to present facts concerning the nature and status of a situation, as it exists at the time of the study and to describe the relationship between directors' ownership and firm performance in Indonesia. In this study, the quantitative approach used is multiple linear regression where firm performance is dependent variable and directors' ownership is independent variable.

1. Data, variable and sample characteristics

The data population is 140 industrial and manufacturing companies listed on the Indonesia Stock Exchange. The population comes from an independent website about listed firms on the Indonesia Stock Exchange. Of the population, 43 companies meet the sampling criteria.

The sampling criteria are as follows:

1. Listed on the Indonesia Stock Exchange on or prior to 2 January 2008 and remain listed until 31 December 2012.
2. Have complete information required in this research.
3. Financial year end at 31 December from 2008 to 2012.

The sample size is considerably small if compared to the population. The smallness of the sample size is largely a result of the incompleteness of information required from the firms. Hence, firms with incomplete required information have to be removed from the samples. In this paper, firm performance is measured with return on assets (ROA). Directors' ownership is measured with the total percentage of common stock owned by the directors. Firm size (measured with total assets) and sales growth serve as control variables.

The research method used in this paper involves the collation of data of 43 manufacturing companies available from online financial databases (secondary data), i.e. Thomson One and Orbis. The research analysis is conducted with the utilisation of a software package used for statistical analysis.

2. Regression Model

To investigate the influence of directors' ownership on firm performance in Indonesia, the following model is used:

$$ROA = \beta_0 + \beta_1 DO + \beta_2 TA + \beta_3 SG + u$$

where:

ROA = return on assets

DO = directors' ownership

TA = total assets

SG = sales growth

D. DISCUSSION

In this section, the empirical results of this research are presented. Before going further, the table of average values of ROA and directors' ownership Indonesia is presented as follows.

Table 1 Average values of ROA and directors' ownership in Indonesia

No.	Variables	Average Values
1.	Return on Assets	6.61%
2.	Directors' Ownership	4.28%

1. Return on Assets

The sampled firms listed on the Indonesia Stock Exchange have an average ROA of 6.61% during the period of 2008 to 2012. The average ROA reached the lowest level in 2008 (3.64%) and it reached its highest level in 2011 (7.58%).

2. Directors' Ownership

Directors' ownership in this research is measured with the sum of common stock ownership of directors in percentage. The directors of sampled firms listed on the Indonesia Stock Exchange have an average common stock ownership of 4.28% during the period of 2008 to 2012. The lowest average occurred in 2008 (3.75%) and the highest occurred in 2012 (4.49%). The majority of the firms have no directors' ownership.

3. Relationship between Directors' Ownership and ROA

The relationship between directors' ownership and firm performance in Indonesia will be investigated below.

Table 2 Regression result of the relationship between directors' ownership and ROA in Indonesia

Coefficients^a

Model	Unstandardized Coefficients		Standardized Coefficients	T	Sig.
	B	Std. Error	Beta		
1 (Constant)	5,4	,8		6,4	,0
Directors' Ownership	-,0	,0	-,0	-1,4	,1
Total Assets	,0	,0	,0	,5	,5
Sales Growth	,0	,0	,2	3,5	,0

a. Dependent Variable: Return on Assets

On Table 2, we can see that the p value of directors' ownership (0.158) is greater than a value (0.05). Therefore, directors' ownership does not significantly influence ROA of firms in Indonesia. Table 1 in Appendix shows that the value of R square is 0.076; meaning that 7.6% of the variation of ROA

can be explained by independent variables in the model and 92.4% of it is explained by other variables not included in the model.

Table 2 also shows that sales growth significantly and positively influences ROA (p value = 0.001). To further investigate such influence, the samples of firms are divided according to their sales growth and then the regression using samples of growing and non-growing firms is conducted. Firms with sales growth above average fall into growing firms' category, and those with sales growth below average fall into non-growing firms' category. The average sales growth of firms in Indonesia in this research is 12.65%. Below are the tables of the regression analysis for both firm groups.

Table 3 Regression result of the relationship between directors' ownership and ROA of growing firms in Indonesia (101 observations)

		Coefficients ^a				
Model		Unstandardized Coefficient		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	9,5	1,4		6,5	,0
	Directors' Ownership	-,1	,0	-,2	-2,1	,0
	Total Assets	,0	,0	,1	1,7	,0
	Sales Growth	-,0	,0	-,1	-1,2	,2

a. Dependent Variable: Return on Assets

Table 4 Regression result of the relationship between directors' ownership and ROA in non-growing firms in Indonesia (114 observations)

		Coefficients ^a				
Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
	(Constant)	6,855	1,269		5,400	,000
1	Directors' Ownership	-,056	,070	-,072	-,800	,425
	Total Assets	-,001	,005	-,025	-,282	,779
	Sales Growth	,254	,061	,375	4,201	,000

a. Dependent Variable: Return on Assets

It appears on Table 3 that directors' ownership has a negative and significant effect on ROA of growing firms in Indonesia (p value = 0.035). Conversely for non-growing firms as shown in Table 4, directors' ownership does not significantly influence ROA (p value = 0.425). In addition, sales growth only significantly and positively influences ROA of non-growing firms (p value = 0).

The results above show that in general, the ROA of firms in Indonesia is not significantly influenced by directors' ownership. This finding contradicts the literature mentioned in this paper which shows positive and/or negative relationship between directors' ownership and ROA. In terms of the relationship between directors' ownership and firm performance in growing and non-growing firms, Tables 3 and 4 show that the influence of directors' ownership on firm performance is stronger in growing firms.

4. Multicollinearity and Autocorrelation Test

In order to check whether the regression models are free from multicollinearity and autocorrelation, collinearity statistics and Durbin-Watson values are used. Multicollinearity does not occur when tolerance value is equal to or above 0.1 (Field, 2013) and variance inflation factor (VIF) is below 5 or 10 (O'Brien, 2007). On the other hand, positive autocorrelation occurs when d is less than d_l (lower bound) and negative autocorrelation occurs when $(4 - d)$ is less than d_u . The multicollinearity and autocorrelation tests show that the regression models are free from these two statistical problems. More details on these tests can be seen in the tables below.

Table 5 Collinearity statistics for regression model of all firms

Coefficients ^a			
Model		Collinearity Statistics	
		Tolerance	VIF
1	(Constant)		
	Directors' Ownership	,9	1,0
	Total Assets	,9	1,0
	Sales Growth	,9	1,0

a. Dependent Variable: Return On Assets

Table 6 R-Square and Durbin-Watson values of regression model of all firms

Model Summary ^b					
Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Durbin-Watson
1	,276 ^a	,076	,063	8,63721	2,175

a. Predictors: (Constant), Sales Growth, Directors' Ownership, Total Assets

b. Dependent Variable: Return on Assets

dl value = 1.338

du value = 1.659

E. CONCLUSION

1. Summary

This paper addresses the question whether directors' ownership influences firm performance in Indonesia. The results presented in this paper conclude that in general, directors' ownership does not significantly influence firm performance in Indonesia. The finding of this paper shows that the argument put forward by Jensen and Meckling (1976) which stated that managerial ownership better aligns managers' interest with those of stockholders does not apply in Indonesian context. In addition, the maximisation of stockholders' wealth which is expected to be achieved through directors' ownership (Hill & Snell, 1989) cannot be confirmed in this paper. The findings of Mehran (1995), Han and Suk (1998), Bhagat and Bolton (2008) and Kaserer and Moldenhauer (2008) are also not supported.

The insignificant relationship between directors' ownership and firm performance found in this paper might be evidence that the policy of share grant in directors' executive remuneration package does not provide an incentive for directors to maximise the shareholder value. Therefore, shareholders are not recommended to include share grant in executive remuneration package.

2. Suggestions

This paper has some limitations that need to be addressed by future researchers:

1. The samples are only collected from manufacturing industry. Future researchers are advised to incorporate samples from all industries to facilitate better and more comprehensive investigation of directors' ownership-firm performance relationship.
2. The relatively small sample size might weaken the validity and reliability of the research in this paper. Future researchers are advised to increase the sample size that can be achieved through incorporation of samples from other industries and/or primary data collection on the firms.
3. This paper does not take into account the directors' affiliation (affiliation to large shareholders, multiple directorship, etc). It is quite possible that this variable influences the relationship between directors' ownership and firm performance. Therefore, future researchers are advised to take into account the directors' affiliation so that it becomes clear whether directors' ownership-firm performance relationship is influenced by directors' affiliation.

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