



# ***The Iniquitous Influence of Family Ownership Structures on Corporate Performance***

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## **ABSTRACT**

*This study investigates the issue of family ownership for Indonesian companies through a detailed analysis of the 'ultimate' share control. A key finding in this study is that ownership type directly impacts on economic performance for Indonesian companies. There are distinct and dramatic differences between the higher return on assets (7.37%) for non-family firms as compared to the far lower profit (1.56%) figures by family-controlled firms. The evidence raises concerns about possible profit manipulation and the entrenchment of profits.*

## **Introduction**

This paper focuses on the potential impact of concentrated ownership and family ownership structures on corporate economic performance. The setting is Indonesia, a country where high family corporate ownership is not only seen but is the normal situation for most listed companies. Major questions arise from such circumstances. How is economic performance affected by ownership structures? Is there an expropriation of wealth to the majority and family-related shareholders whilst disadvantaging the minority and non-family holders?

## **Ownership Structure and the Agency Problem**

One important issue in the organization of firms is how to solve or mitigate the agency problem that derives from asymmetric information. The nature of a corporation's ownership structure will affect the nature of the agency problems between managers and outside shareholders, and among shareholders. But the problems that arise when firm ownership is dispersed are different to those that arise when it is concentrated. When ownership is diffused, as is typical for U.S., U.K., and Japan corporations, conflicts of interest between managers and shareholders are a central problem (Jensen and Meckling 1976). However, when ownership is concentrated to the degree that one owner has effective control of the firm, as is typically the case for firms in Western Europe and the most of Asia, conflicts of interest between controlling

shareholders and minority shareholders becomes the main problem (Fan and Wong 2002).

Claessens, Djankov and Lang (2000) investigate the separation of ownership in selected Asian countries. Their findings indicate that controlling a single shareholder is prevalent in more than two-thirds of the firms in the countries they studied while the separation of management from ownership control was rare. Thus, in Asian countries owners have significant power to pursue their own interests at the expense of minority shareholders, creditors and other stakeholders. As Shleifer and Vishny (1997) point out, controlling shareholders might not have a convergence of interests with minority shareholders. Gaining effective control of a corporation enables the controlling owner to determine not just how the company is run, but also how profits are shared among shareholders. Although minority shareholders are supposedly entitled to cash flow rights proportional to their share of equity ownership, they face the uncertainty that an entrenched controlling owner may opportunistically deprive them of their rights. This creates an 'entrenchment effect' (Morck *et al.* 1988). Higher managerial ownership might entrench managers, as they are increasingly less subject to governance mechanisms (Chang, Hillman, and Watson 2005). Separation of ownership rights and control rights can worsen the entrenchment problems caused by concentrated ownership.

Ownership structure plays an important role in corporate governance. It is a key organisation variable influencing firm outcomes (Kang and Sorensen 1999). Denis and McConnel



(2003) explain that ownership structure refers to the identities of a firm's equity holders and the size of their holdings. Following Boubakri, Cosset and Guedhami (2005) this study divides the shareholding patterns into two major dimensions: the size of ownership (which we further group it into majority and non-majority) and the identity of ownership (which we then group it into family and non-family ownership).

Large investors tend to primarily represent their own interests; they will use their control rights in order to maximise their personal utility from the company (Schleifer and Vishny 1997). This is usually done through paying themselves excessive compensation or special dividends, appointing family members to management positions over other better-qualified candidates, or involvement in potentially-biased related-party transactions (Schleifer and Vishny 1986; DeAngelo and DeAngelo 2000; Anderson and Reeb 2003).

Empirical findings in regard to the relationship between ownership concentration and firm performance have produced inconclusive results. Several studies (e.g., Claessens *et al.* 2000; Thomsem and Pedersen 2000; Chen, Guo, and Mande 2003) document some support for the hypothesis of a positive relation between concentrated ownership structure and firm value. In contrast, many studies failed to confirm a positive association between firm performance and ownership concentration. For example, Demsetz and Lehn (1985), Demsetz and Villalonga (2001) and Himmelberg, Hubbard, and Palia (1999) report that concentrated ownership is not associated with better corporate performance.

Similar to large shareholders, families are more likely to decrease agency costs and increase firm performance due to some reasons. Andres (2008) argues that families usually have invested a substantial amount of their private capital into the firm; therefore they tend to have exceptional concerns over company survival and strong incentives to supervise corporate management's activities. Uniquely, family firms are usually run by close family members, thus, it may eliminate the potential conflict between separate owners and managers (Andres 2008). Families are also experienced at creating a conducive working environment that successfully fosters trust and loyalty resulting in lower employment turnover and recruitment costs (Ward 1988). Based on arguments above, firms that

are owned by family members should lead to more efficient investment and, as a result, be more profitable compared to non-family controlled firms. The potential drawbacks of family ownership is that, instead of maximising firm value, family controlled firms might have incentives to pursue their private benefits at the expense of other shareholders and firm performance (Schleifer and Vishny 1997; Faccio, Lang, and Young 2001). It is also posited that families are more likely to favor family members by filling upper management positions and supervisory board positions which lead to competitive disadvantages compared to non-family firms (Gomez-Meijia, Nunez-Nickel, and Gutierrez 2001; Andres 2008). As consequence of these latter issues, an opposite set of expectations can be generated; family-owned firms tend to result in a negative effect on firm performance.

These conflicting theories have recently evoked a number of empirical examinations of the association between family ownership and firm value. The first set of literature finds a positive link between family ownership and economic performance. Using U.S. Western Europe, Chile and German data. Anderson and Reeb (2003), McConaughy, Walker, Henderson, and Mishra (1998), Maury (2006) and Martinez, Stohr, and Quiroga (2007) and Ehrhardt, Nowak and Weber (2004) note that families businesses are more profitable than non-family companies.

In contrast, the second set of literature notes an inverse relationship between family ownership and performance. For instance, Claessens, Djankov, Fan and Lang (2002) using a sample of firms from Southeast Asian countries, find that family firms' financial performance underperform relative to non-family controlled firms. Similar results are also reported by Cronqvist and Nilsson (2003).

Indonesia, with its very large component of high family ownership and weak regulatory systems, is the perfect setting to explore this potential complicating relationship between family ownership and economic performance.

### **Research Approach**

This project utilises a positivist empirical quantitative research paradigm to answer questions concerning 'what' is the level of economic performance of Indonesian listed companies and 'why' varying ownership structures explain this performance?



To ensure data homogeneity, this study is limited to manufacturing companies identified by the Indonesian Capital Market Directory (ICMD). Another key reason to choose manufacturing firms is that this sector is dominant in Asia and especially Indonesia. As Dhawan, Mangaleswaran, Sankhe, Schween and Paresh (2000, p. 42) states: "Asia has become the workshop of the world: more than half of all manufacturing on Earth is estimated to take place there. The sample examined in this study comprises all manufacturing companies listed on the Indonesia Stock Exchange (IDX) for the longitudinal period 2003 to 2006. There are a total of 166 manufacturing firms listed on the IDX as at the financial statement date 31 December 2006. However, because of company non-disclosure, we are unable to collect sufficient information to construct a full set of proxy measures for 61 entities; therefore, the final usable sample consists of 105 firms.

This study examines the economic performance of manufacturing firms listed in IDX for the accounting years 2003 to 2006 using the ownership structure as the key predictor. Performance is measured using the most frequently-used indicator: rate of return on assets (ROA). ROA is defined as a ratio of net income to total assets. ROE is the division of net income by shareholders' equity. To measure the degree of control, this study combines shareholdings registered in the name of the majority shareholder and other related shareholders (i.e. through shares held by individuals, family or companies that, in turn, are under his/her control). This procedure is the best approach since in Indonesia the majority of the companies listed on the capital market are family controlled. Following Claessens *et al.* (2000), we use the family group as the unit of analysis. By identifying the name under which the shares are registered, this study delineates their family affiliation.

Ownership structure refers to the identities of a firm's equity holders and the size of their holdings (Denis and McConnell 2003). Thus, there are two key dimensions of ownership structure: ownership concentration (ownership type) and the identity of owners (Boubakri *et al.* 2005). Following Murali and Welch (1989) and Holderness and Sheehan (1988), this study categorises ownership concentration as either: majority ownership; or non-majority ownership. Majority ownership is defined if one owner (person, family, family's company), the government

(local or national), or a foreign multinational owns > 50% of the shares in a company. A dummy variable is used to categorise firms, set equal to one if a firm has a majority ownership structure and zero otherwise.

Most prior studies of ownership structure emphasize immediate ownership; that is, common shares directly owned by individuals or institutions. Fan and Wong (2002) argue that immediate ownership is not sufficient for characterizing the ownership and control of Asian firms because these firms are generally associated with complicated indirect ownership structures. Therefore, this study focuses on the ultimate ownership of companies. The ultimate owner is defined as the shareholder who has the determining voting rights of the company and who is not controlled by anybody else (Fan and Wong 2002). The ultimate ownership structures are computed consistent with existing studies (Claessens *et al.* 2000; Faccio *et al.* 2001; Claessens *et al.* 2002; Faccio and Lang 2002) that carefully traced the chain of ownership and identified the ultimate owner(s) that controlled the most voting rights (the controlling shareholder(s) by summing their direct and indirect ownership (voting rights) in a company. In many cases, the immediate shareholders of a firm are themselves corporate entities, or investment companies and other legal entities (Yeh 2005). This study then identifies their owners, the owners of their owners, etc. Following Fan and Wong (2002) economisation of the data collection, the ultimate owner's voting rights level is set at 50% and not traced any further once that level is reached.

This study defines family ownership where an individual, or group of family members, holds more than 20% of a firm's shares (voting rights) and is the largest controlling block in the company. The use of the 20% cut-off point has also been adopted by prior researchers such as La Porta, Lopez-de-Silanes and Shleifer (1999) study of corporate ownership in 27 countries and Claessens *et al.* (2000) investigation of company ownership in nine East Asian countries including Indonesia. La Porta *et al.* (1999), for example, argue that the idea behind using a 20% cut-off is that "this is usually enough to have effective control of a firm" (p. 477). Moreover, according to the Indonesian Capital Market Law (Article (1) 1995 a person that directly or indirectly holds at least 20% of the voting rights of a company is called a 'substantial shareholder'. Similar to La Porta *et al.* (1999) and Claessens *et*



al. (2002), we use the family as the unit of analysis. Family ownership also covers the ownership interests of family members beyond their surnames (i.e. it includes blood and marriage ties) and families are assumed to own and vote collectively. A company is then classified according to data extracted from the ICMD, IBDC, and INFORDEV publications, and firm's prospectuses. A dummy variable is used to identify the firms and is set equal to one if a firm is considered to be family owned (controlled) and zero otherwise.

To control for compounding influences of cross-sectional factors, this study includes auditor type, size and leverage as control variables in the regression analysis. The perceived quality of the auditor is considered to be a possible determinant of the firm financial performance (e.g., Frankel, Johnson, and Nelson 2002; Gul, Chen, and Tsui 2003). Prior research usually distinguishes between non-Big 4 and Big 4 audit firms arguing the latter to be of a higher quality than the former (Heninger 2001; Mayhew and Wilkins 2003). This study includes *Big 4* as a control for perceived auditor quality.

Indicator variable with firm *i* scored one (1) if the firm's auditor in fiscal year *t* is a Big 4 accounting firm; otherwise scored zero (0). A study concerning a nexus between firms' characteristics and their financial performance conducted by Kakani and Kaul (2002) concludes that the firm size is an important factor influencing its financial performance. *Size* is calculated as the natural logarithm of the total assets. *Leverage* is included as prior studies show that financing decisions might influence the firm's profitability (Graham 2000; Booth, Aivazian, Demiguc-Kunt, and Maksimovic 2001). We define *Leverage* as ratio of book value total liabilities to book value total assets.

## Descriptive and Statistical Analysis

### Descriptive statistics

Table 1, Panels A and B, provides the descriptive statistics for the dependent, independent and control variables. Panel A shows the descriptive statistics for the continuous variables and Panel B the categorical figures.

**Table 1: Descriptive statistics**

<b>Panel A – Continuous variables</b>					
	<i>Mean</i>	<i>Median</i>	<i>Standard Deviation</i>	<i>Minimum</i>	<i>Maximum</i>
<i>ROA (%)</i>	3.66	2.45	10.31	-32.51	44.89
<i>Size(million rupiah)</i>	2,559,980	575,781	7,014,880	28,380	48,907,132
<i>Leverage (%)</i>	64.61	54.78	51.30	12.99	334.44
<b>Panel B – Categorical variables</b>					
	<i>Frequency</i>		<i>Percentage</i>		
<i>Owner Type</i>					
<i>Majority</i>	66		62.86		
<i>Non-majority</i>	39		37.14		
<i>Owner Identity</i>					
<i>Family</i>	67		63.81		
<i>Non-family</i>	38		36.19		
<i>Auditor Type</i>					
<i>Big 4</i>	62		59.05		
<i>Non-Big 4</i>	43		40.95		

**Legend:** (N = 105). *ROA*: Ratio of net income to total assets *Size*: Natural logarithm of the total assets. *Leverage*: Ratio of total liabilities to total assets. *Owner Type*: Indicator variable with firm *i* scored one (1) if one owner (person, family, family's company), the government (local or national), or a foreign multinational has a majority ownership (more than 50% of the shares in a company); otherwise scored zero (0). *Owner Identity*: Indicator variable with firm *i* scored one (1) if an individual or group of family members, holds more than 20% of a firm's shares (voting rights) and is the largest controlling block in the company; otherwise scored zero (0) *Auditor Type*: Indicator variable with firm *i* scored one (1) if a company's auditor is a Big-4 audit firm for at least: three out of four year periods or last two years; otherwise scored zero (0).



Panel A in Table 2 indicates that the average of *ROA* performance measure was low at 3.66% and a median of an even lower 2.45%. The size of the companies that are included in the sample has a mean of IDR2,599,980 million with a range of IDR28,380 to IDR48,907,132 million. Average total liabilities to total assets ratio (*Leverage*) of the sample firms is 64.61%. In relation to the ownership structure observed across the sample firms, Panel B of the table indicated that 62.86% of firms are controlled by the owners who have a majority ownership (more than 50% of a company's outstanding share). Panel B also shows that 63.81% of firms are owned by an individual or group of family members. This is consistent with Claessens *et al.* (2000) finding that Indonesian ownership concentration is higher than most other countries, with the major shareholders controlling 61.70% of all corpora-

tions. Finally, 59.05% of firms hired a Big 4 audit firm as their auditor. This figure is slightly higher than the case of Australian and significantly lower compared to Singaporean. In the Australian capital market, 57.54% of firms use a service of the Big 4; while majority of Singaporean firms (86.38%) are audited by the Big 4 accounting firms (Rusmin, Van der Zahn, Tower, and Brown 2006).

### Multivariate analysis

The main results for testing the impact of large concentrated ownership and family-controlled ownership are reported in Table 2. A correlation matrix (not shown for brevity) reveals that there is no significant correlation amongst the two independent variables.

**Table 2: Results of multivariate regression**

	t-stat	Sig.
(Constant)	0.920	0.360
<i>Owner Type</i>	-0.893	0.328
<i>Owner Identity</i>	-2.089	<b>0.039</b>
<i>Auditor Type</i>	1.923	<b>0.057</b>
<i>Size</i>	0.742	0.460
<i>Leverage</i>	-6.666	<b>0.000</b>
<b>Model Summary</b>		
F-statistic	15.515	0.000
R-Square		0.439
Adjusted R-Squared		0.411
Sample Size		105

**Legend:** *ROA*: Ratio of net income to total assets. *Size*: Natural logarithm of the total assets. *Leverage*: Ratio of total liabilities to total assets *Owner Type*: Indicator variable with firm *i* scored one (1) if one owner (person, family, family's company), the government (local or national), or a foreign multinational has a majority ownership (more than 50% of the shares in a company); otherwise scored zero (0) *Owner Identity*: Indicator variable with firm *i* scored one (1) if an individual or group of family members, holds more than 20% of a firm's shares (voting rights) and is the largest controlling block in the company; otherwise scored zero (0). *Auditor Type*: Indicator variable with firm *i* scored one (1) if a company's auditor is a Big-4 audit firm for at least: three out of four year periods or last two years; otherwise scored zero (0).

Regression model estimates reported in Table 2 is statistically significant (F-statistic  $p < 0.01$ ), with an adjusted R-squared of 41.1%. The coefficient on *Owner Type* is negative but statistically insignificant. This finding is in consistent with Demzet and Lehn (1985), Demzet and Villalonga (2001) and Himmelberg *et al.* (1999) results but contrary to the several past studies which suggest that the concentration of shareholders is significantly and positively related to firm performance (Jensen and Meckling 1976; Boubakri *et al.* 2005). The finding also fails to confirm that highly concentrated ownership firms are less productive than firms with widely dispersed ownership structures (Schleifer and Vishny

and Vishny 1986; Schleifer and Vishny 1997; DeAngelo and DeAngelo 2000). Thus, the evidence does not support the notion that a higher level of ownership concentration influences a firm's financial performance. The coefficient on *Owner Identity* is negative and significant (at  $p$ -value 0.039). This result suggests that the presence of high concentrated shareholdings by family members might lower corporate performance. Our finding supports the notion that family control may harm firm performance as reported by Faccio *et al.* (2001) in the case of East Asian firms, Claessens *et al.* (2002) in Southeast Asia, Cronqvist and Neilsson (2003) and Barth *et al.* (2005) both in Sweden and Norway capital



markets respectively and Saito (2008) for the Japanese family firms both owned and managed by the founder's descendants. However, our data regarding the relationship between accounting performance and family controlled firms is contrary to several previous research, for example, Anderson and Reeb (2003), McCaughy *et al.* (1998), Maury (2006), Martinez *et al.* (2007). A backward regression (not shown for brevity) with the best estimation model confirms that *Owner Identity*, *Auditor Type* and *Leverage* are significant predictors of firms' financial performance (at p-values of 0.026, 0.023 and 0.000 respectively).

Further analysis using Independent Samples T-Tests (see Table 3) reveals that the significant association between *Owner Identity* and ROA is driven by the presence of owners in non family-controlled firms. As shown in Table 3, the average return on assets for non-family firms (7.89%) is significantly higher compared to the mean of return on assets earned by the family controlled firms (1.26%). These differences

are dramatic. This result is wholly consistent with the argument that family firms tend to act in the interest of family members, which leads to expropriate wealth from the non-families shareholders (Gomez-Mejia *et al.* 2001; Villalonga and Amit 2006). However, this finding clearly does not support the idea that family businesses perform better compared to non-family firms as documented by, for example, Martinez *et al.* (2007) and Anderson and Reeb (2003). *Auditor Type* is also positively and significantly (at p-value of 0.057) related with ROA. This finding supports the widely accepted conjecture that Big 4 auditors provide a high quality audit. Findings reported in numerous studies document that the Big 4 auditors provide higher quality audit than those non-Big 4 auditors (e.g., Becker *et al.* 1998; Francis, Maydew, and Sparks 1999; Gore, Pope, and Singh 2001; Krishnan 2003). Table 3 shows that the average return on assets of companies audited by Big 4 auditors (6.59%) is significantly higher than average rate of return of non-Big 4 clients (-0.56%).

**Table 3: Descriptive statistics – Owner identity**

	N	ROA			
		Mean	SD	t-value	Sig
Family	67	1.26	9.67	3.316	<b>0.001</b>
Non-family	38	7.89	10.15		
	<b>105</b>				
Big 4	62	6.59	9.78	-3.704	<b>0.000</b>
Non-Big 4	43	-0.56	9.65		
	<b>105</b>				

Finally, the coefficient on *Leverage* is negative and highly significant at p-value of 0.000. This result supports the argument that debt financing decisions might have a negative impact on firm's financial performance. The directional sign and statistical result for *Leverage* is consistent with previous works (e.g., Friend and Lang 1988; Wald 1999; Booth *et al.* 2001; Abor 2005). Those studies examine the effects of firm leverage and profitability and conclude that a significantly negative association between profitability and debt to total assets ratio. *Size* is positively but insignificantly associated with firm financial performance. Geroski, Machin and Walters (1997) examine the association between firm size and profitability on large U.K. companies and report that growth rates of the companies are random over the time, thus, difficult to predict.

## Conclusions

A key finding in this study is that ownership type directly impacts on economic performance for Indonesian companies. There are distinct and dramatic differences between the average return on assets for non-family firms (7.89%) as compared to the far lower earned by the family firms (1.26%). These results raise important questions. Have profit figures been manipulated by these controlling family entities? Are minority owners disadvantaged? Our results show a very possible 'entrenchment effect' wherein the controlling owner dictates not just how the company operates, but also how profits are shared among shareholders. Arguably, minority shareholders are entitled to cash flow rights proportional to their share of equity ownership, yet they face the uncertainty that an entrenched controlling owner may opportunisti-



cally deprive them of their rights. Our finding of far lower reported profits for these family controlled entities adds credence to the concerns about inequitable distributions and entrenched profits.

Our result also shows a positive and significant association between Big 4 audit firms and firm accounting performance, a result interpreted as evidence of Big 4 auditors may provide higher quality audit than non-Big 4 auditors. Finally, we find a significant negative relationship between leverage and economic performance. Lower leverage firms have far higher profits. This relationship may be a remnant of the financial shock suffered by Indonesian companies during and after the 'Asian Currency Crisis'. Indonesian companies are still reeling from high inflation, very low exchange rates and uncertain government policies.

The Indonesian financial market is replete with family-controlled businesses. This leads to concerns about the equitable treatment of minority and small shareholders. Is the playing field balanced? Our findings lead one to the conclusion that they are not equitable or balanced. The evidence raises concerns about possible profit manipulation and the entrenchment of profits. Government policy may need to be changed and more stringent regulations introduced to improve investor confidence and better protect minority shareholder rights.

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