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Internal Corporate Governance and Organisational Performance: Evidence from Indonesia

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Abstract

Despite the growing awareness, in many studies of organisational performance, of the importance of corporate governance, the majority of these studies have been based upon archival data from developed countries with one-tier board systems and have focused on governance structures rather than their performance. This study develops a measure of internal corporate governance based on managers' assessment of the extent to which governance processes are effectively enacted. Reporting the responses of a sample of 496 managers of companies in Indonesia, where two tier boards are the norm, the study reveals that effective internal corporate governance mechanisms are only weakly associated with improved organisational performance.

Introduction

Since the early 1930s, experts have established that the separation of company ownership from control creates a divergence in interests between owners (principals) and managers (agents) (Berle & Means, 1932). Jensen and Meckling (1976) offered one solution by asserting that losses to the principal arising from the divergence of interests may be restricted by enforcing control structures upon the agent. Walsh and Seward (1990) further suggest that such control structures may take the form of either internal organisationally-based mechanisms (e.g., corporate governance) or external market-based mechanisms (e.g., takeover market). This research focuses on the former and its role in improving organisational performance in Indonesian companies.

Banks (2004) defined internal corporate governance in terms of the duties that are performed by a company's governance structures including its board of directors, executive management and independent control functions. Past research has generally

conceptualised internal corporate governance through the actions of the Board of Directors and the structure of executive compensation to align the interests of managers and shareholders. To operationalise these concepts, researchers have almost universally utilised secondary data. For example, Coughlan and Schmidt (1985) measured internal corporate governance using executive compensation, Demsetz and Lehn (1985) with ownership concentration and Hermalin and Weisbach (2003) through the composition of the board.

The majority of studies on internal corporate governance were carried out in developed countries in which the validity of archival data was not subject to debate and capital markets were functioning more efficiently than those of developing countries. When applied in an Indonesian context they have yielded mixed results, with Lukviarman (2004) claiming that controlling shareholders—one form of governance structure in Indonesia—did not improve shareholders' value, while Nam and Nam (2004) concluded that board effectiveness was significantly associated with performance. While inconclusive, these limited studies confirmed the difficulties in analysing secondary data where its availability is restricted through lack of transparency in reporting and its quality suspect due to lack of consistency in accounting regulation and enforcement.

To overcome these shortcomings, a number of authors have proposed the use of primary data to enhance the understanding of the effectiveness of corporate governance (Pearce II & Zahra, 1991; Zahra, 1996; Zahra, Neubaum & Huse, 2000; Daily, Dalton & Cannella 2003; Gill, Flynn & Reissing, 2005). The potential value of this data has also been recognised by Forbes and Milliken (1999), who stated that primary data 'will enable researchers to better explain inconsistencies in past research on boards, to disentangle the contributions that multiple theoretical perspectives have to offer in explaining board dynamics, and to clarify the tradeoffs inherent in board design' (p. 502). This study will therefore adopt primary data sourced via a questionnaire to analyse the effectiveness of a company's governance structure and relate this to perceived organisational performance. The study is also based in a developing country (Indonesia) which operates with a two tier board system, in contrast to the one tier system found in most developed countries. Under this system a board of commissioners (similar to a board of directors) is appointed to supervise a board of managing directors which is responsible for the implementation of strategy.

Corporate Governance in Indonesia

Poor corporate governance was widely acknowledged as one of the main contributors to the Asian monetary crisis of 1997 (Baird, 2000). The Asian Development Bank proposed that the following characteristics were indicative of poor corporate governance in Asian countries: concentrated ownership structure, excessive government intervention, underdeveloped capital markets and a weak legal and regulatory framework for investor protection (Capulong *et al.*, 2000). In the Indonesian context, Lukviarman (2004) studied the characteristics of companies and found similar

features in his study: pyramid ownership structures in the hands of small numbers of families, appointment of family members as members of the board or management team, an ineffective supervisory role due to close relationships between owners and the board, the absence of market control since only small portions of shares are sold to the public and banks which financed the companies were often owned by the same group of companies as the borrowers.

The Indonesian Government has taken steps since 1999 to improve governance standards by establishing the National Committee for Corporate Governance (NCCG) through a ministerial decree (No: *KEP*-10/*M.EKUIN*/08/1999). A year later a revised decree was created (*KEP*-31/*M.EKUIN*/06/2000). In 2004 a further decree was enacted (*KEP*-49/*M.EKON*/11/2004) and the name of the committee was changed to *Komite Nasional Kebijakan Corporate Governance* (NCCG). The main task of the NCCG is strengthening, disseminating and promoting good corporate governance principles, not only in the private sector but also in the public sector.

The private sector also undertook initiatives to improve governance in Indonesia through the Forum for Corporate Governance in Indonesia (FCGI), Corporate Leadership Development in Indonesia (CLDI), the Indonesian Institute for Corporate Directorship (IICD), Indonesian Directors and Commissioners Initiative, the Indonesian Institute of Independent Commissioners, KADIN Corporate Governance Task Force, and the Indonesian Institute for Corporate Governance.

The National Committee of Corporate Governance

Since its establishment, the NCCG has developed a number of guidelines to support the implementation of good corporate governance. In March 2001, the Code for Good Corporate Governance was published by this committee followed by Good Corporate Governance Guidelines for Indonesian Banking in 2004 and the Guidelines for Independent Commissioners and Effective Audit Committee in 2004. The Code for Good Corporate Governance was of particular relevance for this study and was utilised in developing a number of the questionnaire items as outlined in the following methodology section. It contains 13 parts which deal specifically with the roles, rights and responsibilities of the Board of Commissioners and the Board of Managing Directors under the following headings: shareholders, the board of commissioners, the board of managing directors, audit system, corporate secretary, stakeholders, disclosure, confidentiality, insider information, business ethics and corruption, donations, compliance with health, safety and environmental protection, and equal employment opportunity.

Research Method

Structural equation modelling (SEM) was applied to investigate the relationship between internal corporate governance and organisational performance in Indonesia. As outlined below, this study derived an internal corporate governance construct

which consisted of 6 dimensions - namely the Board of Commissioners (BOC), Independent Commissioners (IC), Audit Committee (AC), Board of Directors (BOD), Internal Control Group (ICG) and Codes of Conduct (COC). The perceived organisational performance construct included eight performance criteria: efficiency, customer satisfaction, managerial behaviour, professional behaviour, service quality, contact with clients, position in the market and firm reputation.

Table 1: Demographic Characteristics of Respondents

Demographic Characteristics		Frequency	Percentage (%)
Gender	• Female	108	21.8
	• Male	388	78.2
Age Group	• Under 30	68	13.7
	• 30+ to 40	234	47.2
	• 40+ to 50	139	28.0
	• 50+ to 60	53	10.7
	• 60+	2	0.4
Tenure	• Less than 1 year	10	2.0
	• 1 to 5 years	90	18.1
	• 5+ to 10 years	141	28.4
	• 10+ to 15 years	120	24.2
	• 15+ to 20 years	60	12.1
	• More than 20 years	75	15.1
Type of Business	• Service Business	353	71.2
	• Manufacturing Business	61	12.3
	• Others	82	16.5
Department	• Finance/Accounting	88	17.7
	• Marketing	64	12.9
	• Production/Operation	104	21.0
	• Human Resource Management	36	7.3
	• Others (corporate secretary, internal auditors, communication, and general managers)	204	41.1

Source: Original table.

Following pilot testing, 1000 questionnaires were distributed to managers and executives of companies in three different cities (Jakarta, Surabaya and Yogyakarta). The method applied here was similar to that of Denison (1984) who used the individual respondent in his study of organisational phenomenon on the culture of an organisation. Supporting such an approach were Schein, and Van Aken and Strikwerda (cited in De Witte & Van Muijen, 1999) who argued that, as they were the enablers and the makers of organisations, asking individuals about their perception of organisational phenomena was natural. Individual responses, although applied in many organisational studies, are not immune from deficiency, as acknowledged by Calori and Sarnin (1991). Nonetheless, they deemed this approach appropriate, stating: 'there is bias in asking individuals to respond to questions concerning the whole company. However, it seemed to be a better solution than aggregating specific work group practices and

values, mainly because the surveys do not cover the whole population of the company' (Calori & Sarnin, 1991: 61). In relation to the aggregation technique, Hofmann (1997) claimed that the shortcoming of this approach is that potentially meaningful individual level variance in the items or constructs is neglected.

The response rate of the main study was 66.9 percent. Among the responses, 496 useable questionnaires were tabulated for statistical analysis. Little's MCAR test of .035 indicated that the missing values could be considered to be missing completely at random (Little & Rubin, 2002). As such, any method of replacement was acceptable and series means replacement was used. Kolmogorov-Smirnov's normality test showed there were distribution anomalies in all indicators, but skewness and kurtosis values fell within the acceptable range (±2). With 496 cases, the requirement of minimal sample size of 200 cases for SEM was fulfilled (Hair *et al.*, 1998). The demographic profile of respondents appears in Table 1.

Construct Definition and Measurement

Internal Corporate Governance Construct

In developing an internal corporate governance construct the dimension of duties of companies' organs developed by Banks (2004) was used as a starting point. As the work of Banks was derived from the context of corporate governance systems in western countries, which are based on a one-tier system, adjustments were made in order to better portray the duties of companies' organs in the Indonesian two-tier system. In Indonesia, boards of directors are tasked with the management of the company, and their role is similar to that of executive management in western management structures. Boards of commissioners are tasked with supervising and advising the directors, and are similar to boards of directors in western management structures. As a single variable approach adopted by previous studies was believed insufficient to capture the contribution of corporate governance mechanisms within a firm (Brennan, 2006), this study derived an internal corporate governance construct which consisted of 6 dimensions - namely the Board of Commissioners (BOC), Independent Commissioners (IC), Audit Committee (AC), Board of Directors (BOD), Internal Control Group ICG) and Codes of Conduct (COC).

The dimension of the Board of Commissioners (BOC) was selected as it represented the interests of shareholders and stakeholders by overseeing the fulfilment of the duties of boards of directors and by implementing internal controls. This dimension was applied by Bhagat and Black (1999), Hermalin and Weisbach (2003), Mak and Li (2001) and Gill *et al.* (2005), among many others.

Independent Commissioners (IC) are those that have no affiliation with the company, other commissioners, the board of directors, or controlling shareholders of the company and do not have a business relationship with the company's ultimate business. Examples of previous studies which support the use of this dimension are Bhagat and Black (2002) and Rosenstein and Wyatt (1997).

The duties of auditing and controlling the process of financial disclosure and reporting, and internal control, are the responsibility of the Audit Committee (AC) (NCCG, 2001, 2004; Daniri, 2005). This dimension has also been considered as one aspect of internal corporate governance by past researchers (Olson, 1999; Kurniawan & Indriantoro, 2000).

The Board of Directors (BOD) dimension was selected to represent the role of the board of directors in advancing the company, protecting interested parties, being accountable for the company decisions, and providing full and accurate information. Among others, the works of Rechner and Dalton (1989), Gomez-Mejia and Barkema, (1998) and Desai, Kroll and Wright (2003) have considered the importance of this dimension.

The Internal Control Group (ICG) is essential for the board of commissioners and board of directors to perform effectively. This group of technical experts provides review, assessment and control of a company's operations. In this regard, the internal control group plays a significant role in bridging the daily business activities of the company and the policies launched by higher levels of the corporate structure. This dimension was derived from the conceptual work of Daniri (2005) and the guidance of the National Committee for Corporate Governance (2001).

The last dimension, Codes of Conduct (COC) can be seen as 'the standards for behaviour and action when dealing with those inside and outside of the firm' (Banks, 2004: 47).

Internal Corporate Governance Measures

The six dimensions outlined above are measured through 64 questionnaire items derived from the following sources:

Board of Commissioners - Items summarised from Indonesian Company Law 1995 and the Code for Good Corporate Governance (NCCG, 2001).

Independent Commissioners - Items derived from the Code for Good Corporate Governance (NCCG, 2004) and the Jakarta Stock Exchange Directors' decree No. Kep-315/Bursa Efek Jakarta/06-2000.

Audit Committee - Items obtained from the Code for Good Corporate Governance (NCCG, 2004), the Stock Exchange Supervisory Body circular letter No. SE-03/PM/2000 and the Jakarta Stock Exchange Directors' decree No. Kep-315/Bursa Efek Jakarta/06-2000.

Board of Directors - Items drawn from Indonesian Company Law 1995 and the Code for Good Corporate Governance (NCCG, 2001).

Internal Control Group - Items summarised from the work of Daniri (2005) and material from the Code for Good Corporate Governance (NCCG, 2001).

Codes of Conduct - Items developed by the Code for Good Corporate Governance (NCCG, 2004).

The study asked participants to express the extent of their agreement or disagreement with statements using a 6-point Likert scale. The use of a 6-point scale was supported by Trompenaars and Hampden-Turner (1997), who provided empirical evidence that some Asian countries, including Indonesia, rank high in the neutrality dimension. Consequently, the middle choice of response—namely 'neutral' and 'neither agree or disagree'—was excluded. It was believed that such responses would have contributed to central tendency error (Cooper & Schindler, 2003).

Organisational Performance Construct and Measure

As business organisations have become complex webs of relationships between various claimants (Atkinson, Waterhouse, & Wells, 1997) with multiple and often partly conflicting goals, financial performance alone no longer fully captures the construct of performance measurement. It is for this reason that multidimensional performance approaches, including non-financial or operational and perceptual performance indicators, have emerged (Venkatraman & Ramanujam, 1986; Wilderom, Glunk & Maslowski, 2000).

This study employed a construct adopted from Wilderom and Van den Berg (1998) to measure perceived organisational performance. It includes eight performance criteria: efficiency, customer satisfaction, managerial behaviour, professional behaviour, service quality, contact with clients, position in the market and firm reputation. Participants were asked to express their opinion of the degree their organisation needed to improve in these eight indicators based on a 6-point Likert scale. This approach was supported by the work of Petty *et al.* (1995), Wilderom, Glunk and Maslowski (2000) and Finegold, Benson and Hecht (2007) who stressed that the multidimensionality of an organisation's functions can be best measured with a multidimensional performance approach.

Results

Factor Analysis

Results of the factor analysis revealed 24 observed variables for the internal corporate governance construct and four indicators for the organisational performance construct. For brevity, the results of the factor analysis is not shown here but is available on request from the authors.

Assessment of Measurement Properties

Each construct was subject to a 1-factor congeneric measurement model. Model re-specification was carried out to improve the model fit. In doing so, deletion of non-significant estimated parameters and freeing parameters that shared large error variance was undertaken. This process was ceased when model fit was achieved and

there was neither theoretical nor statistical justification for further modifications. The result of the parameter estimates for the final 1-factor congeneric model is included in Appendix 1.

The 28 observed variables in the models were reduced to 27 items following the 1-factor congeneric model assessment. The item dropped belonged to Board of Commissioners' BOC1 which shared significant error variance with BOC4, and had a lower loading than BOC4. BOC1 measured the extent to which BOCs supervise the action of BODs; this theoretically overlapped with BOC4, which gauged the extent to which BOCs ensure that BODs comply with regulations having the force of law.

Convergent validity measures the magnitude of the direct structural relationship between an observed variable and a latent construct. It is achieved when this relationship (factor loading) is significantly different from zero (Holmes-Smith, 2001). At the five percent significance level the convergent validity requirement was fully satisfied with no *t*-values less than ±1.96. Discriminant validity (Venkatraman, 1989), which represents the extent to which the constructs in a model are different, requires a correlation between constructs less than 0.8 (Holmes-Smith, 2001). Results (Appendix 2 & 3) indicate that the discriminant validity test was satisfied.

Assessment of Reliability

Reliability was measured using squared multiple correlation. It was observed that all indicators satisfied the threshold of .50 (Holmes-Smith, 2001) and their t-values were significant (greater than ±1.96 at 5% significance level), therefore all were maintained (Sethi & King, 1994). In assessing the reliability of multiple measures for an individual construct, the internal consistency measure developed by Fornell and Larcker (1981) was applied. Results of this study indicated that all constructs had good construct reliability (>.50) and good variance extracted estimate (>.50) (refer Hair *et al.*, 1998; Holmes-Smith, 2001). The assessment of reliability test is shown in Appendix 4.

Second-Order Analysis of Internal Corporate Governance Construct

As a second-order construct, internal corporate governance needed to be assessed prior to structural analysis. Model re-specification was again carried out to improve the model fit. This process was stopped when model fit was accomplished and there were neither theoretical nor statistical justification for further modifications (Gerbing, Hamilton & Freeman,1994). After five iterations, the fit indices satisfied the thresholds (Table 2).

The ratio of S-Bχ^2/df was within the acceptable range of 1-2 (=155.958/129=1.209); the *p*-value was greater than the benchmark (=0.0532); RMSEA was satisfactory (=0.0205); GFI was acceptable (=0.909); and CFI's value was excellent (=0.999). The RMR score was not at the recommended benchmark of less than or equal to 0.05. However, as the RMSEA index, which is considered superior to

RMR in terms of its characteristic of being least affected by sample size, was excellent (Fan, Thompson & Wang, 1999), the overall fit indices were acceptable.

Table 2: Model Re-Specification of the Internal Corporate Governance Construct

Fit Index	S-Bχ^2 (df)	*p*-value	RMSEA	RMR	GFI	AGFI	CFI
Results	155.958 (129)	0.0532	0.0205	0.160	0.909	0.880	0.999

Source: Original table.

Assessment of the Structural Model

Results for the full structural model (Table 3) did not necessitate any model re-specification as fit indices were satisfactory. Only RMR and AGFI were outside the recommended benchmarks of 0.05 and 0.90 respectively. However, in line with arguments advanced by Fan, Thompson, and Wang (1999) above, overall fit indices were acceptable.

Table 3: Model Specification of the Full Model

Fit Index	S-Bχ^2 (df)	*p*-value	RMSEA	RMR	GFI	AGFI	CFI
Results	227.748 (202)	0.103	0.0160	0.142	0.900	0.875	0.999

Source: Original table.

The path between the organisational culture construct and organisational performance was measured by Gamma (γ) coefficients (Table 4). With Gamma (γ) coefficients of 0.076, the relationship was positive as expected, although not significant at five percent significance level (*t*-values=1.316).

Table 4: Assessment of the Structural Model

Structural Path	Hypothesis	Gamma (γ) coefficients	*t*-values
Internal Corporate Governance to Organisational Performance	H_1	0.076	1.316 (0.057)$^{\#}$

Source: Original table.

Note: $^{\#}$ not significant at 5% significant level.

Conclusion

Structural equation modelling was applied to test the relationship between internal corporate governance and organisational performance in Indonesia. The finding of a positive though insignificant relationship (at the 0.05 level) implied only a weak association between levels of internal corporate governance and organisational performance.

The study's result is in contrast to a number of previous empirical studies (e.g., Hoskisson, Harrison & Dubofsky, 1991; Himmelberg, Hubbard & Palia, 1999; Thomsen & Pedersen, 2000; Florackis, 2005) which have claimed a positive and significant impact of internal corporate governance on organisational performance.

Nevertheless, these findings are by no means universally accepted. In Australia, Lawrence and Stapledon (1999) found no evidence of a significant relationship. Similarly, studies carried out in Singapore (Mak & Li, 2001), the UK (Faccio & Lasfer, 1999) and two studies performed by Bhagat and Black (1999, 2002) using US data have produced similar results.

This study used a unique approach of applying primary data to address the question of whether governance structures were actively influencing decision-making rather than, as is the case in most prior studies, whether they simply exist. Companies may comply with the form of internal corporate governance in terms of convening Boards of Directors, Boards of Commissioners, Independent Commissioners, Audit Committees, Internal Control Groups and Codes of Conduct; however, they may have little power or influence within the organisation. In this regard, although Daniri (2005) reported the Jakarta Stock Exchange (JSX) has established Independent Commissioners and an Audit Committee in almost 100 percent of listed companies, the Audit Board of the Republic of Indonesia claimed that their duties were rarely executed and proffered this as evidence of very limited governance (BPK, 2007). Prior research relying purely on compliance may have mis-specified the relationship and further research is required using primary data sources to confirm the likely relationship.

The reasons for the non-significant effect of internal corporate governance on organisational performance in this study are arguable. The study is based in a developing country with most prior research being sourced from developed countries. It is reasonable to speculate that this will lead to different outcomes and Tricker's (1994) model of corporate governance provides a possible explanation. In this model, it is proposed that performance roles of governance follow from the compliance roles. It is possible that internal-institution building (i.e., the establishment of a company's corporate governance structures or corporate organs) requires time to be expressed in better organisational performance. The time lag between corporate structures acting and company performance responding was also acknowledged by Leblanc and Gillies (2005).

The finding of only a weak though positive relationship between internal corporate governance and organisational performance raises questions as to the efficacy of improving internal governance standards in developing countries. However, this needs to be tempered with the general observation of a positive relationship in developed countries, particularly the US. A possible explanation for this divergence is that the move from compliance to performance is not instantaneous and it requires stable institutions and enforcement to support regulation. Developing countries such as Indonesia may still be in this transition period. Further research on governance in Indonesia and other developing countries is required before policy implications can be drawn.

Appendix 1: Results of Parameter Estimates of Final One-Factor Congeneric Model

Items	Standardized Loading	Squared Multiple Correlations	Standard Errors	t-values
Board of Commissioners				
BOC4	0.787	0.619	0.097	19.933
BOC8	0.944	0.891	0.043	36.499
BOC9	0.958	0.918	0.059	52.369
Independent Commissioners				
IC4	0.892	0.796	0.054	41.395
IC6	0.960	0.922	0.035	71.835
IC7	0.913	0.834	0.043	44.500
IC8	0.897	0.805	0.063	38.643
Audit Committee				
AC6	0.889	0.790	0.032	39.205
AC7	0.843	0.711	0.060	25.199
AC8	0.927	0.859	0.038	41.037
AC9	0.908	0.824	0.032	41.282
Board of Directors				
BOD7	0.924	0.854	0.021	57.104
BOD8	0.927	0.859	0.020	65.888
BOD9	0.875	0.766	0.032	33.690
BOD17	0.795	0.632	0.051	23.769
Internal Control Group				
ICG1	0.835	0.697	0.051	19.172
ICG2	0.919	0.845	0.034	33.880
ICG3	0.899	0.808	0.039	29.293
ICG4	0.779	0.607	0.051	22.519
Codes of Conduct				
COC4	0.846	0.716	0.041	34.470
COC5	0.907	0.823	0.032	47.447
COC6	0.890	0.792	0.053	30.169
COC7	0.904	0.817	0.056	40.454
Organisational Performance				
OP2	0.884	0.781	0.023	38.301
OP4	0.797	0.635	0.025	31.338
OP5	0.947	0.897	0.023	40.867
OP6	0.868	0.753	0.035	23.075

Source: Original table.

Appendix 2: Correlation Matrix

	BOC	*IC*	*AC*	*BOD*	*ICG*	*COC*	*OP*
BOC	1.000						
IC	.0732	1.000					
AC	0.660	0.738	1.000				
BOD	0.708	0.627	0.725	1.000			
ICG	0.472	0.533	0.662	0.603	1.000		
COC	0.570	0.532	0.648	0.739	0.568	1.000	
OP	0.045	0.004	0.044	0.076	0.073	0.122	1.000

Source: Original table.

Appendix 3: Assessment of Discriminant Validity

	Constructs	Average Variance Extracted	Square of Correlation between Construct	AVE>SC?
BOC with	IC	0.828	0.536	Yes
	AC	0.803	0.436	Yes
	BOD	0.793	0.501	Yes
	ICG	0.770	0.217	Yes
	COC	0.796	0.325	Yes
	OP	0.785	0.004	Yes
IC with	AC	0.818	0.545	Yes
	BOD	0.810	0.393	Yes
	ICG	0.791	0.284	Yes
	COC	0.812	0.283	Yes
	OP	0.803	0.000	Yes
AC with	BOD	0.788	0.526	Yes
	ICG	0.768	0.438	Yes
	COC	0.791	0.420	Yes
	OP	0.781	0.002	Yes
BOD with	ICG	0.759	0.364	Yes
	COC	0.782	0.546	Yes
	OP	0.772	0.006	Yes
ICG with	COC	0.763	0.323	Yes
	OP	0.753	0.005	Yes
COC with	OP	0.777	0.015	Yes

Source: Original table.

Appendix 4: Construct Scale Reliability and Variance Extracted Estimate

Constructs	Construct Scale Reliability	Variance Extracted Estimate
Board of Commissioners	0.973	0.924
Independent Commissioners	0.954	0.839
Audit Committee	0.940	0.796
Board of Directors	0.933	0.777
Internal Control Group	0.985	0.944
Code of Conducts	0.936	0.787
Organisational Performance	0.929	0.710

Source: Original table.

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