RELATIONSHIPS BETWEEN BOARD OF DIRECTOR COMPOSITION, FINANCIAL PERFORMANCE AND SOCIAL PERFORMANCE: EVIDENCE FROM INDONESIA (A RESEARCH PROPOSAL)

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ABSTRACT

Previous studies find mixed results in their attempts to explain the relationship between corporate governance practices, corporate financial performance and corporate social performance. This study examine whether board of directors is related to financial performance and corporate social responsibility practices. It also relates the financial performance and the social performance, vice versa, respectively. The author follows recent study by Sahin, Basfirinci, & Ozsalih (2011) which is conducted in Turkey, an emerging country. The population of this study is Indonesian firms listed in Indonesian Stock Exchanges (IDX) in 2012. This study will use regression analysis. Indonesia has a different corporate governance model than Turkey. By providing evidence from another emerging economy, it is hoped that this study will contribute to the literature on the composition of board of director, CSR practices and the influence of both to financial performance measures.

Keywords: Board of Directors, corporate social responsibility, financial performance

INTRODUCTION

In corporate governance structure, board of directors plays an essential role as internal corporate governance mechanisms. The board represents shareholder's interest and has a consultative function for the management of an entity. It also helps raise public trust for the company (Mentes, 2011).

In Indonesia, there were critics to the board since it is perceived as not of benefit to the company as the individuals in the board are not capable and independent (FCGI, 2003). Many of the individuals were government officials (or ex government officials). Having them as part of the company will make it easier for the company to gain access to the government. In family controlled companies, the decision to appoint member of the board frequently were based on "friendship" or family relationship instead of merit (FCGI, 2003). In these situations many boards of directors would be weak and lack of skills in anticipating crisis in the companies. Therefore ideal composition of board of directors has become an important issue (Machfoedz, 2009).

Board of directors' composition has attracted considerable research interest. Some studies investigate the relationship between board composition and social performance (Mallin & Michelon, 2010; Feiji et al, 2012; Bernardi et al, 2010) between board composition and financial performance (Bermig & Frick, 2010; Rashid et al, 2010, Van Ness & Miessing, 2010, Mentes, 2011, Marimuthu & Kolandaisamy, 2009); and between board composition, social performance and financial performance (Sahin et al, 2011; Ayuso & Argandona, 2007, Ibrahim et al, 2003). However, those studies results in different conclusions on the relationship between variables. Sahin et al (2011) mention that the different results is because of difference in conceptualization, measurement, and interpretation of board composition, social performance and financial performance among researchers.

Van Ness et al (2011) in an Sarbanes Oxley environment find mixed results on the relationship between board composition and financial performance. On the other hand, the influence of the composition of the board concluded as not significant by Bermig & Frick (2010) in Germany and by Rashid et al (2010) in Bangladesh . The composition of the board positively influence social performance by Uwuigbe , Egbide , Ayokunle (2011) , while mixed results found by Lin et al (2011), Elliot et al (2012) , Marsat & Williams, (2010), Van Der Veen & Venugopal, 2011).

This study examined the relationship between the composition of the board with the social performance and financial performance . Previous studies using the triangular model of board composition , social performance and financial performance are Sahin et al (2011) . The study was conducted in Turkish capital markets. Turkey has a different model of corporate governance with in Indonesia. Turkey has its own corporate governance system which is a model of harmony between Anglo America with the continental system. While Indonesia is more continental model since it has two board: board of commissioners and board of directors (Syakhroza, 2005) . This research was conducted in the Indonesian capital market that have different models of corporate governance of Turkey . There are fundamental differences in the application of corporate governance in different countries. The differences are due to the corporate governance structure and the influence of cultural, social, political, and legal model of a country where the company is located on the company (La Porta et al in Syakhroza, 2005).

LITERATURE REVIEW

Agency Theory

Agency theory is developed by Jensen and Meckling in the 1976 publication. Jensen and Meckling explain the agency relationship that arises on the contract between the agent (management) and the principal (owner). In the contract there is a delegation of some decision-making authority from the principal to the agent. Because each party is assumed as a utility maximizer, then there is no reason to believe fully that the agent will act on behalf of the best interests of the owner. It can be seen for example on managers as agents who do not work earnestly in maximizing the value of the company. Aligning this behavior in order to maximize the wealth of the principal agent is an agency problem. This problem in turn will give rise to agency costs consist of the cost of monitoring (monitoring), bonding costs and residual loss (Jensen and Meckling, 1976).

Legitimacy theory

Legitimacy is a condition in which the entity's value system is congruent with the value system of the larger social system, to which the entity is a part of it (Lindbloom in Deegan, 2009). Legitimacy theory states that the organization is always working to make sure that they are perceived to operate still within the limits and norms of society. Since these limitations and norms are always changing, organizations are required to be responsive (Deegan, 2009).

Various strategies / tactics used by organizations to achieve, maintain and repair legitimacy, one of which is the use of annual reports (Deegan, 2009). Legitimacy theory is widely used by researchers to describe social responsibility disclosure practices.

Corporate Governance

In general, there are two models of corporate governance that is characterized by the Anglo-Saxon model of a single (unitary) board (located in countries U.S., UK, Australia) and Continental European models are characterized by a two-tier board (located in the mainland countries of Europe, Japan).

Regardless of the model adopted, such a device would consist of a governance structure, mechanism and principle of governance in which all three forms a system of governance (Syakhroza, 2005). The structure of the organ in the prevailing model in Indonesia consists of 1) AGM, 2) the Board of Commissioners, 3) the Board of Directors. In Indonesia, both the Board of Commissioners and Board of Directors are responsible directly to the AGM. The Board of Commissioners is not as strong as the organs in the continental model Supervisory Board and Board of Directors in the Anglo-Saxon models.

Composition of the Board of Commissioners

The Board of Commissioners is one of the organs of governance which will provide advice and oversee the conduct of the corporation in control of the board of directors. In the two-level model (two-tier system) followed by Indonesia, the company has two separate boards namely the supervisory board (of commissioners) and the management board (directors). The difference between Indonesia’s system and the continental system is in the authority to appoint and remove the board of directors. In the continental system, the authority is under the commissioners while in Indonesia isn’t. (Syakhroza, 2005).

The Board of Directors should not be involved in management tasks and may not represent the company in dealings with third parties (FCGI). Directors of a company chosen by the General Meeting of Shareholders (AGM) for a particular period and may be re-elected.

In Act No. 40 of 2007 on Limited Liability Companies stipulates that the board of one or more members is independent. Independent commissioner is a party unaffiliated with the major shareholders, directors and members of the Board of Commissioners or the other. For issuers and public companies, the presence of independent directors is required by Bapepam-LK (Securities Exchange Commission) through Bapepam-LK No.IX.I.5 Guidelines on the Establishment and Implementation of the Audit Committee. The independent commissioner is chairing the audit committee.

To assist its work, the board of commissioners may establish various committees. In addition to the mandatory intended committee, the remuneration committee, the regulatory committee, nomination committee, corporate governance committee, committee disclosure, social responsibility committee and others may also be formed.

Relationship between board composition and financial performance

Research on the composition of the board of commissioners to use a variety of dimensions such that the effective size of the board in carrying out its functions. Small board size is believed to improve the financial performance and market performance of the company. This hypothesis is supported by empirical research by Sahin et al (2011) and Yermack (1996). Large board size is estimated to worsen and result in sluggish control decisions. Large company with many business segments benefited from the big size of the board because it allows for specialization. However it does not apply to large companies which have relatively simple operations (without a lot of business segments) (Larcker, 2011).

H1a: Size commissioners negatively affect the company's financial performance
Other feature in the composition of the board of commissioners that attract attention is the independence of the board. Independent mind is needed in supervisory functions carried by commissioners. Because of this, the existences of an independent

commissioner become very important. Independent commissioner is expected to provide an objective evaluation of the company and management. It is expected that the decision taken by commissioners can bring maximum benefit for the enterprise. In turn, the greater the independence of the board of commissioners is expected to enhance the company's financial performance.

H1b: The proportion of independent board members has a positive effect on the financial performance of the company.

Relationship between composition of the board and social performance

Large board size will be able to create new problems in coordination and communication. However, the large size of the board can be a representation of shareholders who have a variety of backgrounds and interests. This positive relationship is supported by Dunn & Sainty (2009).

H2a: The size commissioners has a positive effect on social performance

In accordance with Resource Dependency Theory, independent board members are effective in improving the company's image and are able to safeguard the interests of shareholders. It is expected that the larger the independent board members the higher concern for corporate social responsibility. This has been confirmed by Dunn & Sainty (2009).

H2b: The proportion of independent board members has a positive effect on the social performance

The relationship of social performance and financial performance

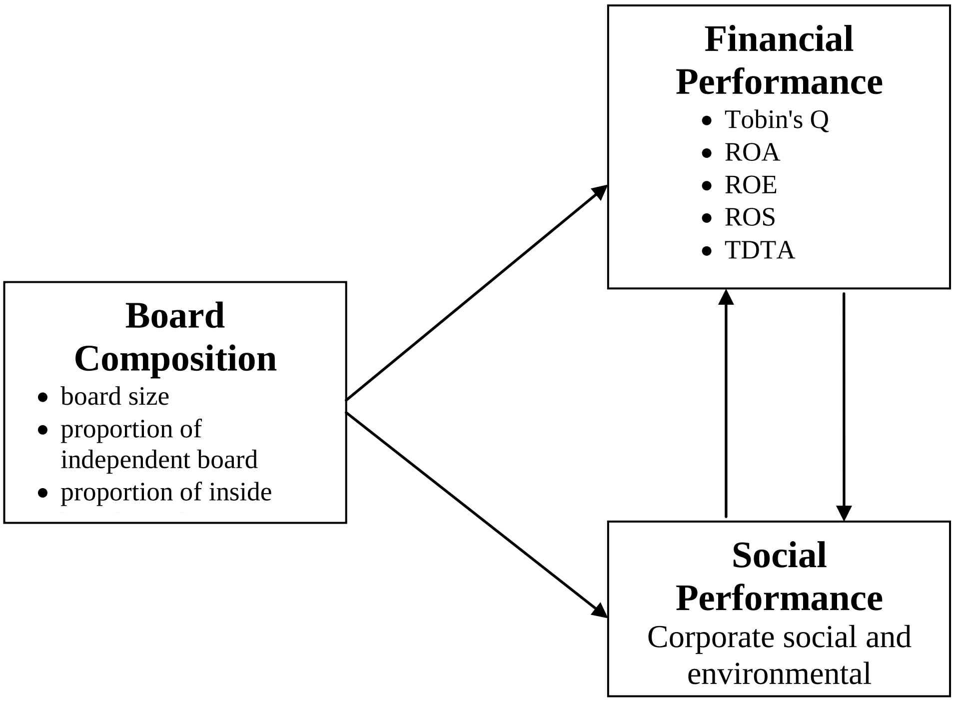
Different results in the relationship between social performance and financial performance is found in literature. In addition, there are diversities in measurement and methodology used in those studies (Jackson and Parsa, 2009 in Sahin, 2011).

The relationship between social performance and financial performance can be explained by the theory of stakeholders. In this theory stakeholder is a party that strongly influence the survival of an organization. Good relations with stakeholder and support from them can result in increased market share and reputation of the company. A well communicated social and environmental activities of a company is expected to enhance the company's financial performance. Instead the company with better financial performance will have more opportunities to realize a good relationship with stakeholders through increased social and environmental activities.

H3a: The financial performance has a positive effect on social performance

H3b: The social performance has a positive effect on financial performance

Research Model



METHODOLOGY AND DEFINITIONS OPERATIONAL VARIABLES

Selection of samples

This study used data from companies listed in Indonesia Stock Exchange in 2009-2011.

Operational Definition of Variables

The composition of the Board in this study was measured by board size and the proportion of independent board, the proportion of board members inside. While financial performance is measured by market-based ratio (Tobin's Q) as well as a variety of accounting-based ratios such as ROA, ROE, ROS and also the leverage ratio as TDTA. Corporate social performance with social and environmental disclosure index was measured using disclosure index from guidelines of Global Reporting Initiatives (GRI). CSR variables obtained from social and environmental disclosures which are divided into five categories and then the arithmetic average was calculated. Public ownership concentration which is the proportion of of public ownership to the total ownership was used as a control variable.

Methods of Data Analysis

The collected data will be analyzed using multiple as well as simple regression analysis. Each regression equation used is as follows:

Model 1

$$Y_1 = \alpha + ß_1 x_1 + ß_2 x_2 + ß_3 x_3 + ß_4 x_4 + ß_5 x_5 + e$$

Description:

Y_1 = financial performance
x_1 = board size
x_2 = proportion of independent board
x_3 = proportion of inside board members
Control variable
x_4 = publicly held shares concentration
x_5 = sector

Model 2

$$Y_2 = \alpha + ß_1 x_1 + ß_2 x_2 + ß_3 x_3 + ß_4 x_4 + ß_5 x_5 + e$$

Description:

Y_2 = social performance
x_1 = board size
x_2 = proportion of independent board
x_3 = proportion of inside board members
Control variable
x_4 = publicly held shares concentration
x_5 = sector

Model 3

$$Y_3 = \alpha + ß_1 x_1 + ß_2 x_2 + ß_3 x_3 + e$$

Description:

Y_3 = social performance
x_1 = financial performance
Control variable
x_2 = publicly held shares concentration
x_3 = sector

Model 4

$$Y_4 = \alpha + ß_1 x_1 + ß_2 x_2 + ß_3 x_3 + e$$

Description:

Y_4 = financial performance
x_1 = social performance
Control variable
x_2 = publicly held shares concentration
x_3 = sector

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