

Does foreign board increase the company's performance? the evidence from Indonesia

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ABSTRACT

This study examined the effect of foreign board members in promoting corporate governance and performance. This study used the fixed effect model from the panel data of 4,282 company-observations over the period of 2007-2017. This study found that the presence of foreign board has a significant and positive effect on the company's performance measured by return on asset and return on equity ratios. On the other hand, the presence of Asian nationality board member was found to have negative significant effect on the company's performance, and this is due to the companies having Asian Board members coming mostly from developing countries. In general, this research show that the presence of a foreign board member can bring differences to the companies and this affects their performance. This means that companies in Indonesia need to increase the number of foreign board of commissioners from outside Asian countries in order to increase their profitability.

ABSTRAK

Penelitian ini menguji pengaruh anggota dewan asing dalam mempromosikan tata kelola perusahaan dan kinerja. Penelitian ini menggunakan model efek tetap dari data panel 4.282 pengamatan perusahaan selama periode 2007-2017. Hasilnya menunjukkan bahwa kehadiran dewan asing memiliki pengaruh yang signifikan dan positif terhadap kinerja perusahaan yang diukur dengan pengembalian aset dan pengembalian rasio ekuitas. Di sisi lain, kehadiran anggota dewan kewarganegaraan Asia ternyata memiliki pengaruh negatif yang signifikan terhadap kinerja perusahaan, dan ini disebabkan oleh perusahaan-perusahaan yang anggota dewanannya berasal dari negara-negara berkembang. Secara umum, penelitian ini menunjukkan bahwa kehadiran anggota dewan asing dapat membawa perbedaan bagi perusahaan dan ini mempengaruhi kinerja mereka. Hal ini berarti bahwa perusahaan di Indonesia perlu menambah jumlah dewan komisaris asing dari luar negara Asia guna meningkatkan kempulabaan mereka.

1. INTRODUCTION

The board member composition is one of the most important issues that associate directly with their structure and function. The diversity on the board of commissioners and board of directors composition is strongly believed being able to affect the company value both in the short term and in the long term. The existence of diversity in the companies' human resources strongly is also believed to be able increase the organization effectiveness, as well as bringing other positive impact on such as increasing the creativity and knowledge for companies' productivity.

One of the issues on the board diversity is a nationality diversity, known as the existence of foreign workforce. Foreign workforce who serve as the board of commissioners and board of directors can provide a several affect to the company. According to Ararat, Aksu, and Cetin (2010), the foreign board can bring a diverse opinion and perspective in form of language, religion, education experience, culture, and professionalism which is different from one country to another, therefore the existence of foreign board can affect the value of the company. King (2007) shows that foreign workforce has better knowledge and experience

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about business aspect on the international level than the local workforce does. This is thought to be able to bring a much more positive impact on the company's performance.

Masulis, Wang, and Xie (2012) found that the existence of foreign workforce serving as the board members can suggest and decide to make the policy that will increase the company's performance. Liargovas and Skandalis (2010) also state that the heterogeneous board member consisting of a diverse nationality will be more creative because they have different perspectives. This condition can generate a better business decisions and strategy rather than the homogenous ones. On the other hand, Tsui, Egan, and O'Reilly (1991) and Williams and O'Reilly (1998) say that the more diverse the board is, in terms of nationality, the more conflict of interest can arise. In addition, the the communication problem among the board members will lead to the poor and less effective decision making.

Indonesia, as the emerging country, is one of the many destinations for the foreign investors. With so many numbers of foreign investors, it will also attract the foreign workforce who are still a minority in the Indonesian companies. In addition, since 2016 Indonesia has been facing the Asean Economic Community (AEC). According to APINDO's (Indonesia Entrepreneur Associations) statistics, concerning the number of foreign workforce in Indonesia as of 2017, it reaches to 74,183 people (APINDO 2017).

In Indonesia, there are no specific rules that govern the existence of foreign board members. In the Law Number 40 about Limited Liability Company, there is no regulation that distinguishes between the foreign and local board members. The first regulation which allowed the existence of foreign board members is stated in "Section 3 and Section 4 1995 Indonesia's President Decision Number 75 about the Usage of Foreign Workforce", where it stated that the director position is widely open to all resources from foreign country. However, there is a rule that governs the position of board of commissioner (BOC)'s and board of director (BOD). It must be filled in with Indonesian citizen that was the "2012 Workforce and Transmigration Minister Number 40". It stated that the Human Resource Director must be an Indonesia citizen. In addition, there is a rule from "2015 Workforce Minister Regulations Number 35 Section 4(a)" that forbids the usage of foreign nationality for board of commissioners, if the company is classified as a domestic investment company (which

the company owned and operated by the Indonesian citizens or the government of Indonesia)

Studies on the effect of the foreign board members on the company's performance is still limited. Most of the research diversity use the age and gender as their main variables but not the nationality (Ararat et al. 2010; Stolk 2011). Yet, the study on the effect of board members diverse nationality is also still very few (Masulis et al. 2012; Miletkov, Poulsen, and Wintoki 2013; Oxelheim and Randøy 2003). In Indonesia itself, the research on the existence of foreign board members or the diverse nationality of board members was only done by Salim (2010) and Kusumastuti and Supatmi (2007), both use companies listed on Indonesia Stock Exchange for the year 2007.

Based on above explanation, this study analyses the effect of the foreign nationality existence in BOC's & BOD's and their impact on the performance of the companies listed on Indonesia Stock Exchange from 2007 to 2017 using Return On Equity (ROE) and Return on Asset (ROA) as the main indicators. This study is organized as follows. First of all, it describes the literature review to support the arguments. Then, the next section describes the data set, variables, and regression method. It also provides the results and finally the discussion ended with the conclusion and contribution.

2. THEORETICAL FRAMEWORK AND HYPOTHESES

Resource-Dependence and Upper Echelon Theory

There are various theories of how the existence of foreign directors affect the company's performance but they provided different results and conclusions. Resource-dependence theory and upper echelon theory generally predict the positive effects. Resource dependence theory stated that the company's successful rate depends on their resources. Companies usually rely strongly on their external environment to survive. One of the key factor to reduce that dependency is creating a linkage relationship with those external entities and acquire those resources. Therefore in this process, board members play important roles as in giving recommendations, legitimation and place for communications (Pfeffer and Salancik 2003).

According to Barney (2000), companies will gain the sustain competitive advantage in the longterm, if they can create a rare resource and have value added that the others cannot get. Dalton, Daily, Johnson, and Ellstrand (1999) state

that the resource dependence theory suggests that the board members are the information sources and critical resources for the company. Moreover, King (2007) mentions that the existence of board diversity (in terms of nationality) whose much more experience and knowledge about global business can bring the valuable information and suggestion for the company's decision making. Therefore, the companies with their diverse nationality of the board members can increase their performance.

Upper Echelon Theory that is developed by Hambrick and Mason (1984) explains that companies choose their corporate strategies and decision making can be affected by their top level management (TLM) characteristics. Hambrick and Mason (1984) state that when explaining the company's behaviour or the way they work can be analyzed by looking at their top level management's characteristics. This theory is also used by several research on the characteristic of top level management and their work satisfaction, employee's commitment, work involvement, and company's financial performance (Fiegen, Nielsen, and Sisson 1996; Theodossiou and White 1998; Westphal and Milton 2000; R. J. Williams, Fadil, and Armstrong 2005). Goll and Rasheed (2005) conclude that the demographics characteristic of the top level managements can affect the company's performance. This can be seen from the way they make decisions. The previous studies also show that the upper echelon theory can be a fundamental analysis for studying about the characteristic of BOC's and BOD's. It is due to their decision making that effects the company's performance. This can be reflected by the characteristic of the board members.

Board Diversity

Harvey and Allard (2015) define diversity as social, cultural, physics, and environmental differences between people that affect the individuals' mind and behaviour. In terms of organization, diversity can be defined as an important characteristic of human beings that affect the individuals and other people's values, opportunity, and perception. These characteristics can be divided into two main groups: primary characteristics (age, ethnic, gender, ability, race) and secondary characteristics (geography, work experienced, income, religion, language, communication style, family status, work style, and education). These differences in every characteristics for every individual eventually will affect the way they are doing anything or work. In the end eventually, it will affect the company as a

whole. As a result of dealing with people from different backgrounds, companies have to develop policies and processes that can minimize misunderstanding and harness the potential benefits of diversity (Tulung, Nelwan, and Lengkon 2012).

In reference to the above description, the diversity on BOC's and BOD's can be defined as the differences from the social, cultural, physical, environmental aspects, and other attributes. Rose (2007) defines the diversity of boards in terms of board members as the composition of BOC's & BOD's and the combination from the qualities, characteristics and abilities that different from every board members. All these are in correlation with the decision making process and any other process in the company. Williams and O'Reilly (1998) asserted that the more diverse the BOC's and BOD's, the more variation of the cognitive ways. Therefore, it can enrich the knowledge, wisdom, ideas, and approach available for the board members. This, and eventually, can increase the quality of complex decision making.

Nationality Diversity

Cultural and nationality diversity on company's management can increase the possibility of communication problem (Lehman and DuFrene 2008) and conflict of interest (Cox Jr 1991). However, the existence of foreign workforce on the company's management is strongly believed to be able to create the company's competitive advantage, such as international connection, increase shareholders' commitment, and avoid managerial entrenchment (Oxelheim and Randøy 2003). Nowadays, the rapid transformation of globalization on business sector can increase the possibility of foreign investors owning a local company (Oxelheim and Randøy, 2003). In the emerging countries that have gained foreign capital inflow, the companies won by the foreign investors usually have a foreign BOC's and BOD's.

Indonesia, as a country with emerging market, is one of the interesting countries that attract foreign investors. By the end of 2017, foreign investors held about 52.2% from total stocks trading in Indonesia Stock Exchange (Indonesia Financial Service Authority 2017). With so much capital inflow from outside Indonesia, the companies owned by foreign shareholders will have higher possibility of diverse nationality on their BOC's and BOD's. Morck, Shleifer, and Vishny (1988) state that the foreign shareholders will trust more on their investment, if there are

foreign board members as their representatives. Thus, they can actively supervise the company's activity.

In Indonesia itself, the existence of foreign BOC's and BOD's are a common things in many companies, in addition after there is ASEAN Economic Community regulation. With so many possibilities of facing a foreign workforce, the Indonesia's Government through the Ministry of Workforce issued the "2015 Ministry of Workforce Regulations Number 35" to control the usage of foreign workforce, so the local workforce still can compete in the market. In that regulation, it specifically stated forbid the usage of foreign nationality for board of commissioners, if the company is a domestic investment company.

For the director position, there is no specific instruction for foreign nationality. The first regulation which allowed the existence of foreign board members is stated in Section 3 and Section 4, Indonesia's President Decision Number 75, 1995 about the Usage of Foreign Workforce/ It is stated that the director position position is widely open to all resources from foreign countries. However, according to Ministry of Workforce Regulation Number 40, 2012, specifically it is stated that for the human resource director and those associated with the government, the company must employ Indonesian workforce.

Hypothesis Development

Nowdays, there is a few studies about the relationship between nationality diversity and company's performance in the emerging countries. So far, the research about the impact of nationality diversity on board members to the company's performance mostly have taken place in the developed countries. The outcomes of the past researches are varied. Oxelheim and Randøy (2003), using Norwegian and Sweden companies as their sample, show that the companies with foreign board members (in this terms Anglo-American board members), have a higher Tobin's Q value.

Ruigrok and Kaczmarek (2008) also found that the diverse nationality on board members have a positive impact on the company's performance, as measured by net income, in the United Kingdom, Netherland and Switzerland. Choi and Hasan (2005), using banking companies in South Korea, concluded that the existence of foreign workforce on the board members has significant impact on the company's performance. For the research in the studies in the emmerging countris, Ararat et al. (2010) found the higher the level of nationality

diversity on board members, the higher the value of it's Tobin's Q.

On the other hand, there are several stuides which conclude that the existence of foreign workforce in the board members doesn't have any impact on the company's performance. For example, Rose (2007), who uses Denmark's companies for the sample, concludes that there is no impact of the existence of foreign board members on the Tobin's Q value. In Indonesia itself, there's still a few number of studies about the impact of foreign board members on the company's performance.

The latest research about it was done by Salim (2010), where he uses Tobin's Q and return on asset (ROA) to measure the company's performance. This research finds that the nationality diversity on board members have a positive but not significant effect on the ROA and negative non significant result on the Tobin's Q, For that reason, it can be concluded that the company's performance is not affected by the existence of foreign board members. Based on the previous studies, thereis a probability of the positive impact of foreign workforce as the company's BOC's and BOD's, on the company's performance. Therefore, the first hypothesis of this research is stated as follows:

H1: Foreign board members have a positive and significant effect on the company's performance

Benfratello and Sembenelli (2006) conduct a research in Italy and argued that the board members from another regions (off-shore) show a negative and significant effect on the company's performance. Since Indonesia is on Asia region, the researchers also tested the impact of ASEAN board members compared to the non-ASEAN board members. Therefore, the second hypothesis in this research is stated as follows:

H2: Asian board members have a significant effect on the company's performance

3. RESEARCH METHOD

This study examined the effect of foreign directors on Indonesian listed companies' profitability. The sample consist of Indonesia-based companies that are listed on the Indonesia Stock Exchange, and they disclosed their annual report for the year 2007-2017. The sample were taken until 2017, which is the latest year. Therefore, the result will be more relevant to Indonesia's current condition.

For the sampling method, this research used the purposive sampling method. Thus, the sample was more adequate with the criteria needed. As for the criteria of the sample are as follows: (i) disclose the annual report for the year 2007-2017, (ii) disclose the profile of the BOCs and BODs on their annual report, (iii) have a complete data related to the variables in this research, such as financial information and data about this research dependent variable and control variable.

After selecting the sample, the researchers obtained 496 companies during the ten-year period, with a total of 4,282 observations. This study used data panel and obtained fixed effect method after conducting the hausman test. However, when conducting a classic original ordinary least square (OLS) assumption test, it means that the researchers want to see if the model in this research is BLUE, there are several classic assumption violations such as autocorrelation and heteroscedasticity. Then, the researchers decided to use generalized least square method to make the model of data panel in this research to become BLUE.

As for the variables, the researchers used five variables to create the model. The company's performance as the dependent variable is measured by the ROA and ROE value. On the contrary, the independent variable is measured by dummy variable of the existence of foreign board member in the company. To finalized the model, we add the firm size, board size and leverage as the control variables, as it is believed that those three variables are the variables that have effects on the company's performance.

The model was used to test the first hypothesis as follows:

$$\text{Firm Performance} = \beta_0 + \beta_1(\text{ForeignBoard})_{i,t} + \beta_2(\text{FirmSize})_{i,t} + \beta_3(\text{BoardSize})_{i,t} + \beta_4(\text{Leverage})_{i,t} + \varepsilon_{i,t} \dots\dots\dots (1)$$

Description:

Firm Performance = ROA where net income is divided by total assets, and ROE is the condition where net income is divided by ordinary shareholders' equity.

Foreign Board = using dummy, value = 1 if there is a foreign board member in the company *i*, otherwise 0

Firm Size = Firm size based on the natural logarithm of company's total sales *i*

Board Size = Natural logarithm from the size of the board *i*

Leverage = Natural logarithm from the company's total liabilities *i*

ε = error term

β_0 = constant

β_x = regression coefficient

The second hypothesis was tested using this model:

$$\text{Firm Performance} = \beta_0 + \beta_1(\text{AsianBoard})_{i,t} + \beta_2(\text{FirmSize})_{i,t} + \beta_3(\text{BoardSize})_{i,t} + \beta_4(\text{Leverage})_{i,t} + \varepsilon_{i,t} \dots\dots\dots (2)$$

Description:

Firm Performance = ROA where net income divided by total assets and ROE where net income divided by ordinary shareholders' equity.

Asian Board = using dummy, value = 1 if there is an Asian board members on company *i*, otherwise 0

Firm Size = Firm size based on the natural logarithm of company's total sales *i*

Board Size = Natural logarithm from the size of the board *i*

Leverage = Natural logarithm from the company's total liabilities *i*

ε = error term

β_0 = constant

β_x = regression coefficient

Basically, there is no difference in the model and method to test both hypotheses. However, the second hypothesis is a derivative of the first hypothesis, where the sample was only 1,496 because they already included companies with foreign board members.

4. DATA ANALYSIS AND DISCUSSION

As seen on Table 1, from a total of 496 companies, the sample in this research, in which the average return on asset is the proxy of companies' performance that is 5.089 with a standard of deviation of 14.020. However, for the return on equity variable A1 and MZ-2, out of a total of 496 companies used as samples, the average return on equity is 7.880 with a standard deviation of 33.211.

The company's size is measured based on the companies' natural logarithm sales, the years of observations. The average natural logarithm figures of the sales from this research is 20.742 with a standard deviation of 2.289. Besides using the company's size, this research also uses leverage level variable which affect the company's performance. It is calculated using the natural

logarithm value of company's total liability on the years of observation. The average liability of the companies' natural logarithm value from this research is 20.688 with a deviation standard of 2.208.

The last control variable is the companies' total

size of board members' calculated using natural logarithm of total sum of board of directors and board of commissioners' members in the observed companies. The average company board member in this research is 2.164 with a standard deviation of 0.350.

Table 1
Descriptive Statistics

	Mean	Std. Deviation	Min	Max	Observation
Company's Performance					
Return on Asset	5.089	14.020	-358.120	219.970	4,282
Return on Equity	7.880	33.211	-443.110	402.860	4,282
Nationality Diversity					
Foreign Board	0.349	0.477	0.000	1.000	4,282
Asian Board	0.826	0.379	0.000	1.000	1,496
Firm Characteristics					
Firm Size	20.742	2.289	0.000	26.051	4,282
Board Size	2.164	0.350	1.386	3.296	4,282
Leverage	20.688	2.208	11.758	27.586	4,282
Sample	496				
Observations	4,282				

Table 2
Hausman Test for The 1st Model

Regression Model	Hausman Test		
	Prob.	Decision	Conclusion
Return on Assets (ROA)	0.000	Reject Ho	Fixed Effect Model
Return on Equity (ROE)	0.000	Reject Ho	Fixed Effect Model

Table 3
Foreign Board Generalized Least Square Result

	ROA	ROE
Foreign Board	1.000**	2.096*
Firm Size	2.499***	4.075***
Leverage	-2.215***	-2.246***
Board Size	3.091***	4.029**
Constanta	-7.954	-39.625
Prob>chi2	0.000	0.000
Observations	4,282	4,282
Sample	496	496
Log -likelihood	-17,172.86	-20,962.46

***, **, and * indicate significance at 1%, 5%, and 10%, respectively

Based on the Hausman test of the first model shown on the Table 2, we decide to use the fixed effect model. Regression result on Table 3, shows there is a positive and significant correlation at a significance level of 5% between foreign boards and company’s performance through the Return on Assets profitability ratio. They also have a positive and significant correlation at 10% significance level between foreign boards and company’s performance through the profitability ration of Return on Equity during the 2007-2017 period. All these means the null hypothesis is rejected. On the dependent variable of Return on Assets, foreign board member has a coeficient of 1.000 which means if there is a foreign board member as a director or as a commissioner, it will increase the company’s return on assets by 1.000. However, on the dependent variable of Return on Equity, foreign board variable have a coeficient of 2.096. It means that if there is a foreign board member as a commissioner or as director, it will increase the company’s return on equity by 2.096.

This result is in line with several previous studies such as that by Estélyi and Nisar (2016),

stating that the presence of foreign director had a significant effect at 1% level. According to Estélyi and Nisar (2016), the presence of foreign director has a positive effect on the company’s performance because the foreign board member can bring new experience, perspective, and opinion that can increase company’s performance.

Ararat et al. (2010), Peck-Ling, Nai-Chiek, and Chee-Seong (2016), Ruigrok and Kaczmarek (2008) also found the same result. Oxelheim and Randøy (2003) state that the foreign nationals presence in the management of a company can give a competitive advantage for the company, like international links, increased shareholders commitment, and avoid managerial entrenchment. King (2007) states that a director with foreign nationality is usually equipped with various experiences and knowledge about environment and global business practices. It can also manage better resources in the company as compared to the domestic directors (Peck-Ling et al. 2016). Ararat et al. (2010) mention that foreign board member can bring positive things like opinion and varied perspectives, education experience, life culture, and different professionalism.

Table 4
Hausman Test for The 2nd Model

Regression Model	Hausman Test		
	Prob.	Decision	Conclusion
Return on Assets (ROA)	0.000	Reject Ho	Fixed Effect Model
Return on Equity (ROE)	0.000	Reject Ho	Fixed Effect Model

Table 5
Asian Board Generalized Least Square Result

	ROA	ROE
Asian Board	-2.037*	-4.659*
Firm Size	2.511***	3.913***
Leverage	-2.900***	-2.738***
Board Size	4.554**	5.550
Constanta	5.718	-23.238
Prob>chi2	0.000	0.000
Observations	1,496	1,496
Sample	191	191
Log -likelihood	-6,242.696	-7,467.348

***, **, and * indicate significance at 1%, 5%, and 10%, respectively

The same as the first model, the hausman test result showed it used the fixed effect model as shown on Table 4. Asian board is a dummy variable used as proxy on the presence of board member coming from Asian countries in companies that have foreign board members. The regression results on Table 5 shows a negative and significant effect at a significance level of 10% between ASEAN board members and the company's performance through profitability ratio of Return on Assets during the period of 2007-2017. Yet, on Return on Equity ratio, there is also negative and significant correlation at a significance level of 10%.

The dependent variable of Return on Assets, Asian board has a coefficient of -2.037 which means, if there is a commissioner or director foreign board member coming from Asian countries, it will lower the company's Return on Assets by 2.037, while on the Return on Equity, the Asian board member has a coefficient of -4.659 which means that, if there is a foreign board member coming from Asian countries, it will lower company's Return on Equity by 4.659.

This is in line with statement by Bilyk (2007), stating if a company has capital or board member coming from developed countries they will have better performance as compared to those having board member coming from developing countries. Yet, companies having capital or board member coming from developing countries, the performance is affected negatively (Mihai 2014). In this case, Asian Countries has the largest board member contributor to companies in Indonesia and they are developing countries such as Malaysia, Thailand, China, India, and Philipines.

5. CONCLUSION, IMPLICATION, SUGGESTION, AND LIMITATIONS

This study attempt to see the relationship of diverse nationalities represented by the presence of foreign national directors or commissioners and the company's performance of those listed in Indonesian Stock Exchange during the period of 2007-2017. Using a total of 496 sample companies and a total of 2,486 observations, this study concludes that diversified Nationality or the presence of foreign nationals serving in the board of commissioner or the board of director has a positive and significant on the companies' performance measured using the profitability ratios of ROA and ROE.

This is due to the presence of director or commissioners as believed to give knowledge, information, experience, working culture, and different professionalisms that help to increase the

companies' performance. The foreign nationality directors are equipped with various experiences and knowledge about environment and global business practices. Therefore, all these can better manage the companies' resources as compared to those coming from domestic countries.

Directors and Commissioners coming from Asia are found to have negative effect as compared to the non-Asian countries. This is due to the countries in Asia that are still developing countries as compared to the non-Asia countries which are developed countries. In this case, it can be also concluded that the presence of directors or commissioners coming from developing countries can give a negative effect as compared to those coming from developed countries.

This research also has some contributions to several related elements. Looking at the research findings, it indicates companies that have not used foreign nationals as board of director members or board of commissioner members have to consider using the service of foreign board members in order to increase their performance. These directors or commissioners are already equipped with various experiences and knowledge on environment and global business practice. All these can better manage the companies' resources as compared to those coming from the domestic.

For the academics, this research contributes to providing additional literature on foreign nationals diversity affecting the companies' performance in developing countries. The previous studies had mostly used the samples taken from developed countries. As for regulators, the government can revisit the laws and permits governing the use of foreign workers and simplify the procedures for companies to use foreign national workers. On the other side, the positive effect of having foreign nationals can also pose a threat to the local directors and commissioners who will then lose competitiveness as compared to foreign workers. The government would also need to review the laws and regulations in limiting the use of foreign directors or commissioners to protect local directors and commissioners from losing to their foreign counterparts.

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