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THE IMPACT OF OWNERSHIP STRUCTURE, BUSINESS DIVERSIFICATION AND COMPANY SIZE ON COMPANY PERFORMANCE: A SEM APPROACH

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ABSTRACT

This study examines the influnce of ownership structure, business diversification and company size on company performance that listed in Indonesia Stock Exchange (IDX) in the periode of 2000-2011. Population of this study is all listed companies in IDX in the periode of analysis and based on purposive sampling 284 companies-years were selected. The final sample is 206 companies-years after outlier and normality tests was executed,. To answer the research queations, structural equation modeling was used. Confirmatory factor analysis (CFA) is employed to verify construct validity of the measurement model. The structural model then determines the impact of ownership structure, diversification of business and company size on company performance. The study found that the hypothesized measurement model fits the data as shown by the goodness of fit indices and the significant factor loadings. It means that the hypothesized measurement model fits on the data collected. The structural model indicated that ownership structure, which consists of insider ownership, institutional ownership and foreign ownership, did not have effect on company performance. Nevertheless, shareholder dispersion had a positive and significant influence on company performance. This showed that the public investors could be an effective monitoring agent to reduce agency conflict and increase company performance. Similarly, diversification of business was also found to be a negative and significant in influencing company performance. Company size negatively and significantly affected company performance. The listed companies in IDX could not reap benefit of diversification and company size.

Keywords: Performance, Ownership structure, Diversification and SEM

JEL Codes: G32, G34

1. Introduction

When an entrepreneur or an owner owns all company shares, there is no conflict of interest at all between the owner and the management. However, when an entrepreneur sells a fraction of the share to outside investors, an agency conflict between the principal (owner) and the agent (manager) might appear. This is because the owners of the company hire managers to provide some services for them and thus the managers should act according to the interests of shareholders or the owners. In reality, however, a manager tends to make decisions based on his or her interests rather than on the shareholders; particularly on issues related to diversification of business and company size. This is because as the size of a company gets larger through diversification of the company's business activities, higher would be the perquisites provided to managers.

Diversification may take place when a company operates in more than one business segment, and it could either create or destroy the value of the company (Berger & Ofek, 1995). The destruction

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usually occurs if companies fail to exploit the benefits of diversification which include cost savings, greater efficiency and synergy among divisions through sharing of company assets, increasing debt capacity and economies of scope. In fact, the cost of diversification comes from the agency relationship when managers choose to diversify their interests. Managers can avoid the destruction by allocating resources correctly or avoiding over investment in a poor division which can reduce the company's value. Normally, managers diversify or increase a company's size to defend themselves to avoid a takeover. Such agency problems generally lead to increased agency costs.

Larger company size can also affect company performance as shareholders face some difficulties in monitoring managers and knowing whether or not the managers are pursuing shareholders' wealth maximization. A larger company is usually supported by skilled employees but it can be related to high agency costs. It is believed that without effective monitoring, benefits of economies of scales cannot be achieved. Driffield, Mahambare and Pal (2007), Gupta (1969), and Lang and Stulz (1994) indicated that a larger company generally outperforms a small company because the former provides benefits of economies of scale, easy access to funds and human capital investment.

Theoretically speaking, when managers diversify business and enlarge company size based on shareholders' interest, their decisions could hopefully increase shareholders' wealth and thus contribute to company performance. Such an ideal situation might not exist as managers normally act based on their interests. As a result, an agency conflict might arise between shareholders and managers. Therefore, a mechanism to mitigate agency conflict between managers and shareholders is needed.

According to Jensen and Meckling (1976), ownership structure could be used a mechanism to overcome agency conflict. Company performance is usually influenced by ownership structure. Ownership structure can be a means to reduce agency costs related to the separation between control and ownership. This separation may cause an agency conflict. To solve such a conflict, *agency theory* suggests that companies should seek the ownership structure that allows managers to realize the full potential of a company's assets. The ownership structure, in this case, refers to the distribution of shareholding which includes insider ownership, institutional ownership, foreign ownership, and shareholders' dispersion. The following section would explain underlying theories and empirical evidence, method, result and implication of this study.

2. Agency Theory

Agency relationship is a common phenomenon in a large company. When the owner or principal owns 100 percent of the stock of a company, there is no agency relationship and no separation between corporate ownership and control. The principal is the manager and the owner at the same time. This means that the entrepreneur bears all the costs and reaps all the benefits because of his or her action. Once a fraction 'α' of the company's stock is sold to an outside investor, the entrepreneur bears only '1- α' of the consequences of his or her action (Jensen, 1986; Jensen & Meckling, 1976). Therefore, the separation between ownership and control of the company (Berle & Means, 1932) creates agency conflict between owners and agents (Jensen & Meckling, 1976). In other words, there is a conflict of interests between outside shareholders and the managers of a company. This leads to the possibility that managers may make decisions based on their interests at the expense of the shareholders. As a result, such conflict of interests causes a market reaction, which reduces company value. This loss of company value is known as agency cost of equity. Therefore, agency theory exists to explain about the relationship between principal (owners) and agent (managers).

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Jensen and Meckling (1976) define agency relationship as a contract under which one or more persons [principal(s)] engage another person (the agent) to perform some services on their behalf which involves delegating some decision making authority to the agent" (p.5). Based on this definition, an owner hires an agent to act on the former's interests. It is expected that the agent would utilize the company resources efficiently to improve performance. In reality, however, an agent does not always act in the best interests of the principal because the owner could diversify his/her investments, while the manager is limited to his/her human capital only. Agency relationship becomes a problem when the owner delegates the decision making power to an agent. This problem would not exist if an agent could align his or her interest with the owners' interest based on a perfect contract. Agency theory is developed to predict behaviour of the agent and the owner based on an assumption that an agent pursues the welfare of owner (Byrd, Parrino, & Pritsch, 1998). According to Eisenhardt (1989), agency problems exist when (1) there is a conflict between the objective of the owner and the agent; and (2) there exists asymmetric information where the owner could not predict behaviour of the agent.

Jensen and Meckling (1976) explained that agency cost will increase since there is an agency relationship between manager and shareholders where there is inherent conflict of interest between manager and shareholders. Principal could diversify their investments while manager cannot diversify his/her human capital. This conflict must be addresed which cause appearance of agency cost. If both parties' relationship is considered fully maximized, each party tends to pursue his/her interest, there is a good reason to believe that the agent will not always act in the best interests of the principal. The principals can limit divergences from their interest by establishing appropriate incentives for the agent and incurring monitoring costs designed to limit the aberrant activities of the agent. In some situations, shareholders will pay the agent to expend resources (bonding costs) to guarantee that he/she will be compensated if he/she does take such actions.

However, it is generally impossible for a principal or agent to ensure at zero cost that the agent will make optimal decisions from the principal's viewpoint. In most agency relationships, the principal and the agent will incur positive monitoring and bonding costs (both non-pecuniary - i.e. loss of reputation for manager when he/she make suboptimal decision, and pecuniary costs) and there will be some divergences between the agent's decisions and decisions that would maximize the welfare of the principal. Jensen and Meckling (1976) define agency costs as a sum of (1) the monitoring expenditures by the principal, which refers to dollar value used to ensure that the agent will act based on the principals' interests, (2) the bonding expenditures by the agent, which refers to compensation when he/she does not act on the principal's interests, and (3) the residual loss, which is the dollar value that will be paid by the principal and the agent if monitoring and bonding mechanisms do not work.

In summary, the conflict between manager and shareholders will influence a company's performance. Therefore, there is a need for a mechanism to align manager's self-interests with that of shareholders. According to Jensen and Meckling (1976), there is a tendency for a large company to face agency problems because of the separation of function between decision making and risk bearing. In this situation, a manager tends to use company's additional returns to consume perquisites (e.g. purchase of a corporate jet). This might reduce the company performance. Such situation is known as equity agency cost. In order to minimize the conflict between insider ownership and outside shareholders, a monitoring mechanism is needed to align their interests. Such mechanism can generate agency cost for the company although it is intended to reduce overall agency cost.

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To overcome agency problems and reduce attendant costs, several mechanisms can be used. The first approach is to increase insider ownership as the agency problem can be reduced if managers hold shares of the company (Crutley & Hansen, 1989; Jensen & Meckling, 1976). Managers will not act as an opportunist since they will also bear the consequences of their decision. Moreover, holding shares of a company is an incentive for a manager to increase company performance and to use debt optimally in order to minimize agency cost. If a manager holds 100 percent of a company's shares, then agency cost will be eliminated as the manager and the owner become one and the same. This approach is known as the motivational mechanism. Secondly, there should be an institutional investor as a monitoring agent since the institutional investor, such as banks, fund companies, and other institutions, has an incentive to monitor performance of a manager in an efficient manner. Bathala et al. (1994) stated that institutional investors are important monitoring agents who have an important role to control their investment in a company. This monitoring mechanism will ensure an increase in shareholders' satisfaction.

According to Shleifer and Vishny (1986), large shareholders such as institutional investors can monitor managers effectively and reduce the power abuse among them. The significance of institutional investors as monitoring agents is captured by their sizeable equity of investments in the stock market. If institutional investors are dissatisfied with managerial or stock performance, they can simply sell their holdings i.e. follow an exit policy. However, the exit policy has become increasingly difficult for many institutions because it has become increasingly more expensive because they must accept substantial discounts in order to liquidate their holdings (Coffee, 1991). Moreover, as an active monitoring agent, institutional investors attempt to enhance managerial accountability through various means. In some instances, institutional investors seek a special seat on the board to protect their interests. Furthermore, institutions have an oversight on companies through the formation of shareholders' advisory committees that serve to review operating and financial results of the company.

Foreign ownership is the next mechanism to mitigate agency conflict. As for local investors, foreign investors have greater interest to ensure that the company can generate returns (Pound, 1988) and they can use their voting rights to control the manager. Therefore, the emergence of foreign investors causes managers to act more carefully and pursue shareholders' best interests. This could mitigate agency conflict and contribute to company performance. Distribution of shares among 'outside shareholders' (other than manager and insider ownership) is another approach to mitigate agency costs that might affect company performance (Moh'd et al., 1998). Since ownership indicates a source of power that can be employed to either support or oppose existing management, concentration or dispersion of that power becomes relevant. Moh'd et al. (1998) used two measures of outside shareholders concentration. The first proxy was institutional investors where their arguments concentrated on disciplining performance. The natural log of the number of outstanding shareholders was the second proxy. Rozef (1982) argued that the greater the number of shareholders, the more diffused is the ownership (Moh'd et al., 1998), hence a negative relationship should be expected between the number of shareholders and company performance.

The above discussion implies that managerial ownership and institutional ownership are useful in mitigating agency costs. However, these mechanisms are not without cost. Excessive managerial ownership of common stock may lead to entrenchment problem. Voting and take-over mechanisms would probably fail if managers are unwilling to invest too much of their personal wealth. Moreover, even too much institutional ownership may have costs associated with it. Some have argued that institutional ownership increases stock price volatility while others suggest that it induces short-term

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myopia in management. If institutional investors are dissatisfied with performance of a manager, they tend to sell their share and this situation might cause a sharp decline in stock prices.

3. **Ownership Structure**

Ownership structure refers to the distribution of shares held by individuals or institutions in a company. According to Cui and Mak (2002), Demsetz and Lehn (1985), Driffield et al. (2007), Holderness and Sheehan (1988), Jensen and Meckling (1976), Kumar (2005), McConnel and Servaes (1990), Morck et al. (1988), Randoy and Goel (2003), Shleifer and Vishny (1986), Short and Keasey (1999), and Wei (2007), the ownership structure of equity is associated with company performance because it was found to reduce agency costs due to the separation between ownership and control (Barbosa and Laori (2002) as cited by Kumar (2005)). In this sense, ownership structure might be a mechanism that can be used to mitigate agency costs. Firstly, ownership structure affects capital market growth. While concentrated ownership usually misallocates the capital in an economy, dispersion of ownership structure might promote capital market as it is easy for investors to enter or exit the capital market (Maher and Anderson (1999) as cited by Yet and Guan (2005)). This is indicated by a large number of shareholders in a company. Secondly, ownership structure functions as a monitoring and managing mechanism through the market control to reduce misallocation of funds that might support a company's performance (Fama & Jensen, 1983; Short et al., 2002).

Furthermore, Berle and Means (1932) and Jensen and Meckling (1976) suggest that the company's ownership structure is a primary determinant of agency problem between controlling insiders and outside investors, which has important implication for the valuation of the company. The insiders who control corporate assets can potentially expropriate wealth from outside investors by diverting resources for their personal use or by committing funds to unprofitable projects that provide private benefits (Lemmon & Lins, 2003). This would provide an opportunity to increase their current wealth or perquisite consumption without their having to bear the full cost of their action. Alternatively, by investing resources within the company in positive NPV projects, managers have the opportunity to increase their future wealth in proportion to their claims on the company's future cash flow. Further, agency theory suggests that companies should seek the ownership structure that may allow the corporate manager to realize the full potential of company assets.

In addition, large public companies tend to have more concentrated ownership. Shleifer and Vishny (1989), as cited by Anderson and Reeb (2003) stated that concentrated shareholders are quite common and documented that over 77 percent of the Fortune 500 companies have at least one shareholder owning five percent or more of the company. This situation also holds true for companies listed on the IDX which indicated by on average shareholders own company shares at least 5.8 percent in the descriptive statistics of this study. Large and concentrated shareholders can impose costs on the company where those costs are not present in companies with diffused ownership. These costs can take many forms, including expropriating wealth from small investors in the form of special dividends, excessive compensation package, and risk avoidance. Diversified shareholders generally evaluate the projects on the basis of maximizing residual cash flows, while large-concentrated shareholders may derive greater benefit from pursuing company growth, technological innovation, or company survival, which might be based on their self interests.

Some researchers have argued that concentrated ownership structure or group affiliations are prone to carry inefficient investment and expropriate wealth from minority shareholder in emerging market such as Indonesia (Claessens & Fan, 2002; Denis & McConnel, 2003; La Porta, Lopez-de-Silanes, Shleiffer, & Vishny, 2002). In some cases, large controlling shareholders are alleged to have

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expropriated corporate wealth to the detriment of the corporations, minority shareholders and creditors (Lemmon & Lins, 2003). In short, expropriation by inside shareholders is a more relevant issue in emerging countries where the legal protection of minority shareholders is relatively low.

Previous empirical studies have analyzed the impact of ownership structure on company performance (Chen & Ho, 2000; Danco, 1975; Driffield et al., 2007; Holderness & Sheehan, 1988; Kumar, 2005; Lemmon & Lins, 2003; McConnel & Servaes, 1990; Ming & Gee, 2008; Morck et al., 1988; Poza, 1989; Randoy & Goel, 2003; Rogers, Dami, & Ribeiro, 2008; Sulong & Nor, 2008; Tagiuri & Davis, 1989; Ward, 1987; Zeitun & Tian, 2007). Sulong and Nor (2008) conducted their study on 406 listed companies on the Kuala Lumpur Stock Exchange (KLSE, now known as Bursa Malaysia) in 2002 and 2005. In their study, ownership structure included various types of ownership such as ownership concentration, government ownership, foreign ownership and managerial ownership. They found a significant positive relationship between government ownership and inverse relationship of foreign ownership on company value of Tobin's Q in the year 2002. However, their study reported that ownership structure (ownership concentration, government ownership, foreign ownership and managerial ownership) had insignificant effect on Tobin's Q in the year 2005. On the other hand, Driffield et al. (2007), who conducted a study on non-financial companies in Indonesia, Korea, Malaysia, and Thailand in the period 1994-1998, found that ownership structure has a positive and significant effect on Tobin's Q in four countries.

4. Diversification of Business

Diversification of business is explained by the number of business segments a company owns. If a company has only one business segment, it is known as a focused company. On the other hand, if the company has more than one business segment, it is called a diversified company. Diversification of business is anticipated to have an effect on company performance. Berger and Ofek (1995) argued that diversification can either create or destroy company value. They found that diversified companies trade at a significant discount of approximately seven percent as compared to a single-segment company in an emerging capital market. Afza, Slahudin, and Nazir (2007) stated that diversification may be related to higher performance, which may be attributed to increased market share, economies of scale, and better exploitation of resources. However, agency problem and divergent approach of managers may result in lower profitability.

Existing literature remains inconclusive on the effect of diversification on company performance. While some researchers reported a positive impact of diversification on a company's performance, others reported a negative effect. However, the most of previous studies were carried out in developed economies. Very few studies that focused on diversification and company performance in emerging markets were conducted. Furthermore, recent evidence shows that diversification has not been beneficial for U.S. companies over the last three decades. This indicates that, on average, companies have not been able to exploit the potential benefits of diversification while controlling the costs. Studies during the late 1960s and early 1970s have provided evidence on the benefits of corporate diversification. Chandler (1977) argued that companies with multiple divisions lead managers to use the company's assets effectively among business divisions. As a result, it could increase company value. Weston (1970) states that resource allocation is more efficient in internal capital market than in external capital markets. He therefore suggested that diversified companies allocate resources more efficiently because they have a larger internal capital market. Resource relatedness, or the use of common resources in multiple businesses, creates synergies in the form of economies of scope (Davis & Thomas, 1993).

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Thecee (1980) noted that a wider economies of scope through corporate diversification needs more capital. Diversified corporations have a greater debt capacity than corporations with a single segment of similar size (Lewellen, 1971). Generally, cost of debt is cheaper than cost of equity. This circumstance probably increases company value since there is interest tax shield. Cost savings can also be generated by a combination of gain segments and loss segments in a diversified company that can reduce total corporate income tax. Majd and Myers (1987) suggested that as long as some segments of a diversified company incur losses in some periods, the overall tax liability of the multiple segment corporations will be less than that of single segment companies. However, corporations that focus on a single segment would not be able to save costs from the interest tax shield. In addition, Williamson (1985) argued that diversified companies reap the benefits of internal capital markets, which are less costly than external capital markets due to their ensuring better allocation of resources among competing projects, more efficient information sharing, and more effective post-investment monitoring and control. Stulz (1990, 1999) suggested that by avoiding the need to go to external capital markets for funds, diversified companies can mitigate the underinvestment problem (Myers, 1977).

In contrast, diversification of business also creates additional costs. If any, the costs of diversification are generated primarily from agency problems (Afza et al., 2007; Jensen, 1986; Lins & Servaes, 1999; Meyers, Milgrom, & Roberts, 1992; Stultz, 1990). Jensen (1986) and Stulz (1990) noted that managers may diversify to enhance company size and to benefit from prestige, power and compensation from managing a large company. Since managers are able to avoid market evaluation and monitoring of their projects, Mathur, and Gleason (2004), and Stulz (1990) and Singh argued that managers in corporate diversification usually invest in business or projects with negative NPV (Net Present Value) that could reduce company value. Given that diversification can facilitate creation of internal capital markets and help increase debt capacity, Jensen (1986) argued that managers with larger debt capacity and access to free cash flow may undertake nonvalue-maximizing investments. Further, due to the inter-segment transfer of cash, there is a greater possibility of managers undertaking negative value projects relative to single-segment companies. Similarly, Meyers et al. (1992) also argued that unprofitable line of business can create greater value loss in conglomerates than they would as stand-alone companies.

5. Company size

Company size had an ambiguous effect on company performance (Kumar, 2005) because it can either increase or decrease company performance. Large companies might turn out to be more efficient as they are likely to exploit economies of scale, employ more skilled managers, and have greater specialization and formalization of procedures, all of which might lead to better performance (Driffield et al., 2007; Gupta, 1969; Lang & Stultz, 1994). It also measures a company's market power or the level of concentration in the industries. Transaction costs involved in the issuance of securities are also related to company size (Gupta, 1969; Smith & Watts, 1992). In particular, small companies face some difficulties and pay much more than large companies when issuing new equity and long-term debt. On the other hand, larger companies have easier access to the capital market since they have a large assets base as a guarantee.

Mickkelson, Parch, and Shah (1997) suggested that larger companies tend to have better performance than small companies. Some authors found that company size had a significant positive effect on company performance (Chakrabarti et al., 2007; Chen & Ho, 2000; Kumar, 2005; Ming & Gee, 2008; Serrano-Cinca et al., 2007; Short & Keasey, 1999; Titman & Wessels, 1988; Zeitun & Tian, 2007). Short and Keasey (1999) reported that company size has a significantly positive effect on

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performance because larger companies have the potential to access funds with greater ease, both internally and externally and have better growth opportunities. Larger companies may have greater analyst following and thus have more information available to reduce information asymmetry and a wider share spread and ownership profile. Accordingly, many past studies have used total assets as a proxy for company size. Alternatively, another proxy for company size commonly used in prior research is market capitalization represented by logarithm function of market capitalization (LOGMCAP).

On the other hand, Yermack (1995) and Gaver and Gaver (1993) noted that larger companies had more difficulty in monitoring the managers. The agency costs increase as the size of a company increases (Jensen & Meckling, 1976). Larger companies can be less efficient than smaller ones because of the loss of control by top management over strategic and operational activities within the company (Himmelberg et al., 1999; Sarkar & Sarkar, 2000). Lang and Stulz (1994) suggested that company value decreases as it becomes larger and more diversified. Large size does not ensure benefits of scale. Size only provides an opportunity for economies of scale and may not be achieved without adequate strategies and actions (Abell & Hammond, 1979). Akhavein, Berger, and Humphrey (1997) and Berger and Humphrey (1992) revealed that challenges such as coordination, motivation and conflicts of interest are bigger in large companies. Therefore, there is a negative relationship between company size and company performance (Li, Lam, Qian, & Fang, 2006). This could be the result of a number of factors such as lack of focus or a lesser degree of transparency in managerial actions. Capon, Farley, and Hoenig (1990) performed a meta-analysis of 320 published studies and found that size appeared to be unrelated to financial performance. They also found some evidence supporting a positive relationship when size is measured by industry-level sales.

6. Theoretical Framework

Based on the theory, structural equation modeling of comapany performance is developed as exhibited in Figure 1. The model shows that there are exogenous and endogenous constructs. The first four constructs refer to ownership structure. It is an exogenous observed variable that includes insider ownership (Insdr), institutional ownership (Inst), foreign ownership (Forg) and shareholder dispersion (SDP). All exogenous observed variables influence company performance (H1a, H1b, H1c and H1d).

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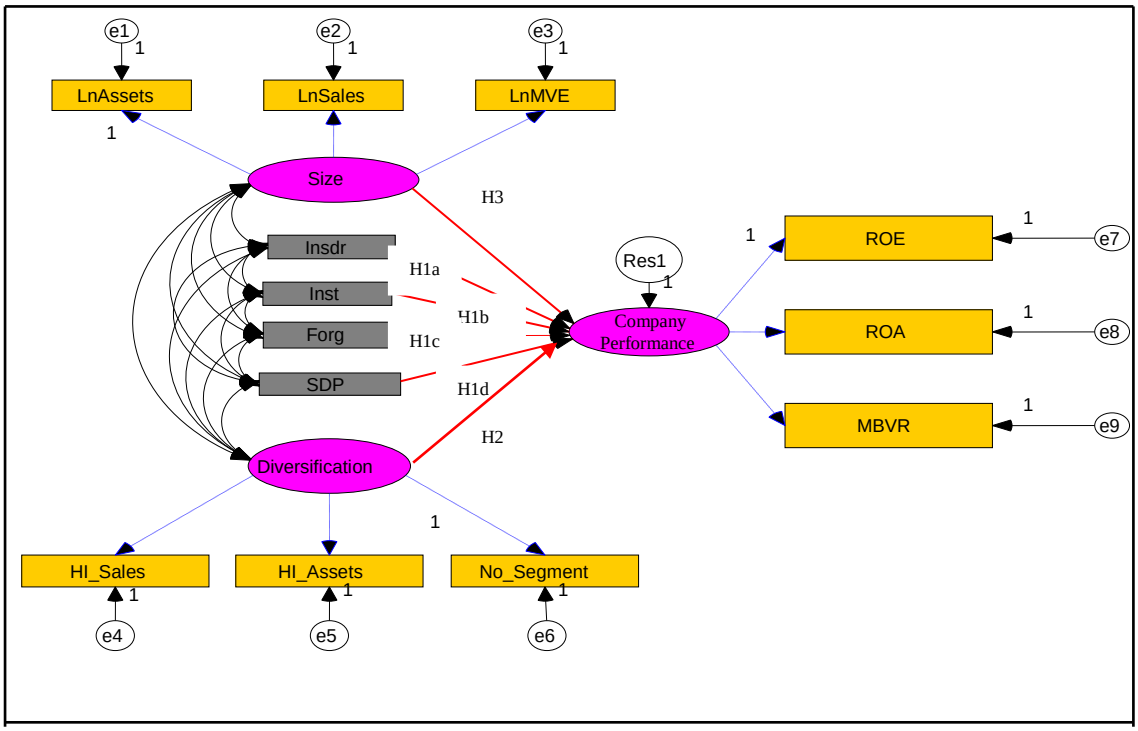

Figure 1: Structural Equation Modeling of Company Performance

Diversification of business is the fifth exogenous construct that has an effect on company performance (H2). The sixth construct is company size postulated as having a relationship to company performance (H3). The endogenous construct is company performance, which is predicted by ownership structure, diversification of business and company size. Furthermore, all of the variables in Figure 1 could be explained in Table 1.

Table 1: Variables in This Study

Construct	Description	Dimension of Construct
Insider ownership (Insdr)	Exogenous observed variable	
Institutional ownership (Inst)	Exogenous observed variable	
Foreign ownership (Forg)	Exogenous observed variable	
Shareholder dispersion (SDP)	Exogenous observed variable	

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Diversification of Business	Exogenous latent variable	• Herfindahl index by sales (HI_Sales) • Herfindahl index by total assets (HI_Assets) • Number of business segments (No_Segment)
Company Size	Exogenous latent variable	• Natural log of total assets (LnAssets) • Natural log of total sales (LnSales) • Natural log of MVE (LnMVE)
Company Performance	Endogenous latent variable	• ROE • ROA • MBVR

7. **Methodology**

7.1 Sample and data collection method

Population of this study is all listed companies in Indonesia Stock Exchange (IDX) in the period of 2000-2011. Based on purposive sampling, 284 companies-years were selected and once outlier test was conducted, the final sample of this study is 272 companies-years. Data is collected from Indonesian Capital market Directory (ICMD) and audited financial report.

7.2 Meaurement of variable

This study uses a different proxy to measure the variables and different multivariate techniques as compared with other studies. Table 2 described the measurement of company performance. This study employs accounting base measures (ROE and ROA) and also market base measure such as MBVR.

Table 2: Measures of Company Performance

Company Performance	Description
$ROE = \frac{\text{Net Income}}{\text{Equity}}$	ROE indicates the ability of equity to generate return. This study measures ROE as ratio between net income and equity (Chen & Ho, 2000; Cui & Mak, 2002; Demsetz & Villalongga, 2001; Kumar, 2005; Randoy & Goel, 2003; Rogers et al., 2008; Short & Keasey, 1999).
$ROA = \frac{\text{EBIT}}{\text{Total Assets}}$	ROA shows the ability of company assets to generate return. ROA is measured as ratio between EBIT (earnings before interest and taxes) and total assets (Li et al., 2006; Moh'd et al., 1998; Titman & Wessels, 1988; Zeitun & Tian, 2007).

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$\text{MBVR} = \frac{\text{Debt} + Market Value\ of\ Equity}{Debt + Book\ Value\ of\ Equity}$	**MBVR.** Market value is market value of common stock and debt. Market value of company is measured by closing price of stock at the fiscal year end while debt is book value of debt (Kumar, 2005; Short & Keasey, 1999; Zeitun & Tian, 2007).

Ownership structure included insider ownership, institutional ownership, foreign ownership and shareholder dispersion. Table 3 explained the measurement of each variable.

Table 3: Measures of Ownership Structure

Ownership Structure	Description
$\text{INSDR} = \frac{Number\ of\ shares\ held\ by\ managers\ and\ directors}{Number\ of\ common\ shares\ outstanding\ at\ the\ end\ of\ fiscal\ year}$	Insider ownership (INSDR) is percentage of shares held by managers and directors (Bathala et al., 1994; Moh'd et al., 1998; Rozef, 1982).
$\text{INST} = \frac{Number\ of\ shares\ held\ by\ institutions}{Number\ of\ common\ shares\ outstanding\ at\ the\ end\ of\ fiscal\ year}$	Institutional ownership (INST) is percentage of shares held by institutions (Bathala et al., 1994; Kumar, 2005).
$\text{FORG} = \frac{Number\ of\ shares\ held\ by\ foreigners}{Number\ of\ common\ shares\ outstanding\ at\ the\ end\ of\ fiscal\ year}$	Foreign ownership (FORG) is percentage of shares held by foreign investors (Kumar, 2005).
$\text{SDP} = \frac{Number\ of\ shares\ held\ by\ public\ investors}{Number\ of\ common\ shares\ outstanding\ at\ the\ end\ of\ fiscal\ year}$	Shareholders dispersion (SDP) is developed as percentage of shares held by public investors.

Diversification of business has thre indicators such as Herfindahl index by sales, Herfindahl index by total assets and the number of business segments. Their measurement could be seen in Table 4.

Table 4: Measures of Diversification of Business

Diversification of Business	Description
$\text{HI\_Sales} = \sum_{i=1}^{n} \text{Fraction of sales of segment i}^2$	Herfindahl Index by sales (HI_Sales) is sum of squared value of sales per segment as a fraction of company sales (Lang & Stultz, 1994).

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$\text{HI\_Assets} = \sum_{i=1}^{n} \text{Fraction of asset of segment i}^2$	Herfindahl Index by assets (HI_Assets) is sum of squared value of assets per segment as a fraction of company assets (Lang & Stultz, 1994).
$\text{No\_Segment} = \text{Number of business segments}$	Segment is number of business segments of company (Berger & Ofek, 1995; Chen & Ho, 2000; Denis et al., 1997; Lang & Stultz, 1994).

Compay size also has three dimension which consist of the natural log of total assets, the natural log of sales and the natural log of market value of equity. All of the dimension are measured as follows.

Table 5: Measures of Company Size

Company Size	Description
$\text{LnAssets} = \text{Natural log of total assets}$	LnAssets is the natural log of total assets (Li et al., 2006; Mitton, 2002; Serrano-Cinca et al., 2007).
$\text{LnSales} = \text{Natural log of sales}$	Lnsales is measured as the natural log of sales (Kumar, 2005; Mitton, 2002; Titman & Wessels, 1988).
$\text{LnMVE} = \text{Natural log of market value of equity}$	LnMVE is the natural log of MVE. Market value of equity is measured as common stock outstanding multiply by closing price at the fiscal year end (Hull, Mazakech, & Ockree, 1998).

7.3 Technique of analysis

Structural equation modeling (SEM) was used since this study as some of the variables have been conceived as latent constructs such as diversification, size (Bowden, 2000; Serrano-Cinca, Fuertes-Calle, & Gutierrez-Nieto, 2007; Titman & Wessels, 1988) and company performance (Serrano-Cinca et al., 2007; Shen, Hsu, & Chen, 2006) that cannot be directly observed**.** Some studies have measured these variables as latent constructs. Although many more studies have measured these variables directly observed variables (Berger & Ofek, 1995; Lang & Stulz, 1994; Lemmon & Lins, 2003; Rogers et al., 2008; Zeitun & Tian, 2007), it was thought that it would be more interesting to measure these variables as latent constructs, as this was hoped (at the time) to give a fresh and insightful set of findings that may be different from these using the mainstream and entrenced way of measuring the variables. Ownership structure in this study is observed variable which consist of insider ownership, institutional ownership, foreign ownership and shareholder dispersion. SEM refers to factor analysis and regression as one technique where it does not only look into the influence of independent variables (ownership structure, diversification of business and company size) on dependent variable (company performance) but also confirms that the latent variables are manifested by their dimensions. The measurement model highly recommended before testing the structural model since SEM is a two-step approach (Anderson & Gerbing, 1982). Only a valid construct and model fit could be included in the structural model.

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In brief, SEM confirms the relationship through CFA with an objective to assess construct validity and model fit. The measurement models have been conceived here include the relationship between (1) diversification of business and its indicators, (2) company size and its measures and (3) company performance and its dimensions. .As with other models, SEM also tests hypotheses relationships between ownership structure, diversification of business and company size with company performance.

8. Finding & Discussion

SEM is a two step aprroach. The measurement model trhough CFA is highly recommended before doing the structural model. This study was done the overall measuremenf model for the all latent variable as showed by Figure 2. The results showed that the model can fullfill convergent validity which means the indicators can explain the latent variables.

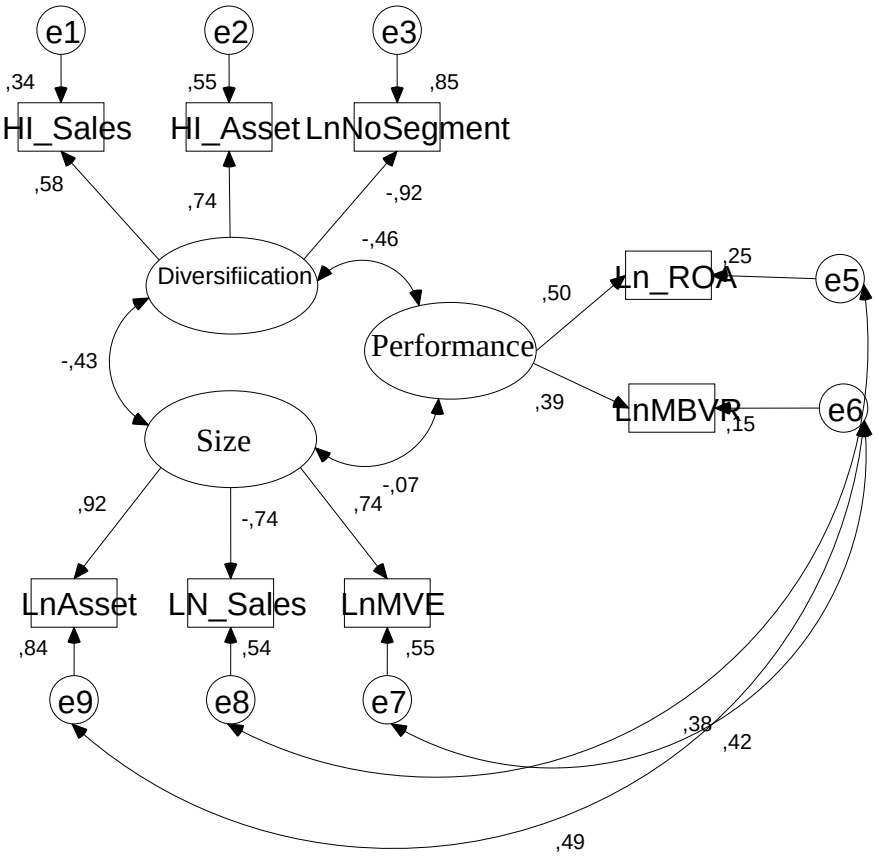

Figure 2: Overall measurement model

According to Anderson and Gerbing (1988) as cited by Ferdinand (2006), Hair et al. (2006), and Tabachnick and Fidell (2007), there are several ways to assess convergent validity such as factor loading, variance extracted, critical ratio, and construct reliability. Table 6 indicated that all the factor loadings are significant at 0.001 level, with loading values ranging from 0.39 to 0.92. According to Tabachnick and Fidell (2007), the factor loadings with a value more than 0.3 showed a convergent validity.

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Tablel 6: Output of overall CFA

Latent	Dimensions	Stand. Loading (SL)	SMC (SL^2)	Error Variance (1-SMC)	Stand. Error	C.R	P
Performance	Ln_ROA	0.50	0.25	0.75	0.02	2.31	0.02
	LnMBVR	0.39	0.15	0.85			
	∑	**0.89**	**0.40**	**1.60**			
	Construct Reliability	**0.33**					
	Variance Extracted		**0.20**				
Diversification	HISales	0.58	0.34	0.66			
	HI_Assets	0.74	0.55	0.45	0.17	7.97	0.00
	LnNoSegment	-0.92	0.85	0.15	0.45	7.99	0.00
	∑	**2.24**	**1.74**	**1.26**			
	Construct Reliability	**0.79**					
	Variance Extracted		**0.58**				
Size	LnAssets	0.92	0.85	0.15	0.08	11.196	0.00
	LN_Sales	-0.74	0.55	0.45	0.09	10.252	0.00
	LnMVE	0.74	0.55	0.45			
	∑	**2.40**	**1.95**	**1.05**			
	Construct Reliability	**0.84**					
	Variance Extracted		**0.65**				

C.R: Critical Ratio; P: Probability

The company performance had factor loadings as follows: 0.39 (MBVR) and 0.50 (ROA) and 0.20 (ROE). Since the factor loading of ROE is less than 0.30 so that indicator was deleted from the model. Hence, the construct of company performance could only explained by MBVR and ROA, but accounting based measure (MBVR) is the most important because it has a higher factor loading (0.50). Moreover, indicators of diversification of business had factor loadings as follows: Herfindahl index by sales (0.58), Herfindahl index by assets (0.74) and the number of business segments (-0.92). This shows that all measures could manifest diversification of business. Although all are significant but the number of business segments (-0.92) represents diversification of business latent better than other indicators. Finally, company size could be explained by its manifests since the natural log of total assets, the natural log of sales and the natural log of MVE had factor loadings of 0.92, -0.74, and 0.74, respectively. All factor loadings are significant and are more than 0.3, which showes that

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convergent validity was achieved. Nevertheless, among the three indicators representing company size, the natural log of total assets is closely linked to company size because it has a higher factor loading (0.92). This is a contribution of SEM.

Additionally, the standardized loadings (SL) and critical ratios (C.R were double the standard error) indicated the convergent validity was fulfilled (Anderson and Gerbing (1988) as cited in Ferdinand (2006)); specifically their values were ROA (SL = 0.50, C.R = 2.31, 2SE = 0.04), HIAssets (SL = 0.74, C.R = 7.97, 2SE = 0.34), LnNoSegment (SL = -0.92, C.R = 7.99, 2SE = 0.90), LnAssets (SL = 0.92, C.R = 11.196, 2SE = 0.16) and LnSales (SL = -0.74, C.R = 10.252, 2SE = 0.18) . All figures showed that the latent variables (diversification of business, company size and company performance) could be manifested by their own indicators; hence convergent validity could be achieved.

Similarly, the variance extracted and construct reliability of diversification of business and company size achieves the convergent validity because their values were more than 0.5 for variance extracted and 0.7 for construct reliability (Hair et al., 2006). Specifically, diversification of business had variance extracted of 0.58 and construct reliability of 0.79 while company size had variance extracted of 0.65 and construct reliability of 0.84. Company performance had variance extracted of 0.30 and construct reliability of 0.20. This indicated that diversification of business, company size and company performance were reflected well by its own indicators as suggested by the related theory.

The results also show that discriminant validity was established when none of the correlations among the constructs were more than 0.9 (Hair et al., 2006). The lowest and highest correlations were -0.07 (company size and company performance) and -0.46 (business diversification and company performance), whereas the correlation between diversification and size was -0.43. Further, the square of correlations among the constructs (0.21 for diversification and company performance, 0.004 for size and company performance and 0.18 for diversification and size) were less than variance extracted for each construct (VE of company performance = 0.33, VE of diversification = 0.58, VE of size = 0.65). It shows that each of the latent constuct explains its indicators better than it explains other constructs. Therefore, this study could fulfill discriminant validity. In brief, when the measurement model could fulfill convergent and discriminant validity, the CFA would have better fit. This means the measurement models fit the data collection in listed companies on the IDX. Table 6 exhibits the output of overall CFA which included standardized factor loadings, construct reliability, variance extracted, SMC, critical ratio, standard error and p value.

The square of standardized factor loadings or SMC represented how much variation in an item or an indicator or a manifest was explained by a latent factor. Herfindahl index by sales had SL 0.58 with SMC 0.34. This means diversification could explain 34% of the variation in Herfindahl index by sales with the other 66% being error variance. Herfindahl index by total assets (the number of business segments) could be explained 55% (85%) by diversification since its SMC was 0.74 (-0.92). Company size could explain the natural log of sales (55%), the natural log of MVE (55%) and the natural log of total assets (86%), which are indicated by its SMC. Additionally, this study found that any change in MBVR and ROA could be explained by company performance with SMC values of 15% and 25%, respectively, and the remaining variance was explained by its error variance.

Moreover, Table 7 presents that the overall measurement model was a good fit since its GOF could achieve the cut off values (χ^2/df ratio = 1.73, GFI = 0.97, AGFI = 0.90, CFI = 0.98, TLI = 0.96 and RMSEA = 0.06). However, chi-square statistics was significant (χ^2 = 24.165, df = 14 and p = 0.044) (Bagozzi & Yi, 1988). A significant chi-square might be due to type I error in which there is a rejection

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of null hypothesis. Chi-square is very sensitive to sample size; therefore, this study used other GOF indices (such as shown in Table 7) to decide whether the model is fit. This was suggested by Tanaka (1993), and Tomarken and Waller (2003). In brief, measurement models in this study were valid and fit.

Table 7: Goodness of Fit Indices of Overall CFA

Goodness of Fit Indices	Statistic	*Cut off Value*	Decision
Chi-Square (χ^2)	24.165	Lowest	
Df	14		
Probability (p-Value)	0.044	≥0.05	-
Ratio	1.73	≤3.00	Better fit
GFI	0.97	≥0.90	Better fit
AGFI	0.90	≥0.90	Better fit
CFI	0.98	≥0.94	Better fit
TLI	0.96	≥0.95	Better fit
RMSEA	0.06	≤0.08	Better fit

Source: (Byrne, 2001; Ferdinand, 2006; Hair et al., 2006); GFI: *Goodness of fit index*; AGFI: *Adjusted* GFI; CFI: *Comparative fit index*; TLI: *Tucker Lewis index*; RMSEA: *The root mean square error approximation*.

Having satisfied all the requirements of measurement model (CFA), a structural model was executed to assess the model-data fit and the hypothesized relationships among the constructs which is developed based on theory. Based on some statistical outputs, the structural model showed acceptable fit. The chi-square statistics is not the sole criteria for identifying model fitness because χ^2 statistics possess very high power when sample size is large (MacCallum, Browne, & Sugarawa, 1996)Instead, this study used CMIN/DF or χ^2/df ratio, CFI, GFI, TLI and the RMSEA to assess the model fit. It was found that CFI , GFI> 0.90 (Bentler & Bonnett, 1980), Ratio < 3 (CMIN/DF = 2.10) and RMSEA < 0.08 (RMSEA = 0.07) (Browne & Cudeck, 1993). All these are reported in Table 8.

Table 8: Goodness of Fit Indices of the structural model

Goodness of Fit Indices	Statistic	*Cut off Value*	Decision
Chi-Square (χ^2)	71.55	Lowest	
df	34		
Probability (p-Value)	0.00	≥0.05	-
Ratio	2.10	≤3.00	Better fit
GFI	0.95	≥0.90	Better fit
AGFI	0.90	≥0.90	Better fit
CFI	0.95	≥0.94	Better fit
TLI	0.90	≥0.95	Good
RMSEA	0.07	≤0.08	Better fit

Sources: (Byrne, 2001; Ferdinand, 2006; Hair et al., 2006); GFI: Goodness of fit index; AGFI: Adjusted GFI; CFI: Comparative fit index; TLI: Tucker Lewis index; RMSEA: The root mean square error approximation.

The structural model in Figure 3 postulated that ownership structure, diversification of business, and company size influenced company performance. As such, it attempted to provide an answer on the six hypotheses as follows.

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8.1 Insider ownership is related to company performance.

The results show that the relationship between insider ownership and company performance was statistically insignificant where its p-value was 0.55 which was more than 0.05. Hence, the Hypothesis 1a, insider ownership is related to company performance, was not accepted. This finding was not consistent to the agency theory (Jensen & Meckling, 1976). Insider ownership as a mechanism to mitigate agency conflict could not be applicable in IDX. The insignificant result shows that insiders could not influence company performance in Indonesia.

The finding of this study was consistent with previous empirical studies that found insider shareholdings could not influence company performance (Demsetz, 1983; Himmelberg et al., 1999; Ming & Gee, 2008; Sulong & Nor, 2008). Demsetz and Himmelberg et al. conducted their studies on U.S. companies while the studies of Ming and Gee, and Sulong and Nor were done in the Bursa Malaysia (previously known as Kuala Lumpur Stock Exchange [KLSE]). This finding does not support the study of Agrawal and Knober (1996), Cui and Mak (2002), McConnel and Servaes (1990), Morck et al. (1988), and Randoy and Goel (2003) where they found that managerial ownership contributed positively to company performance in developed capital markets such as the U.S. and the U.K.

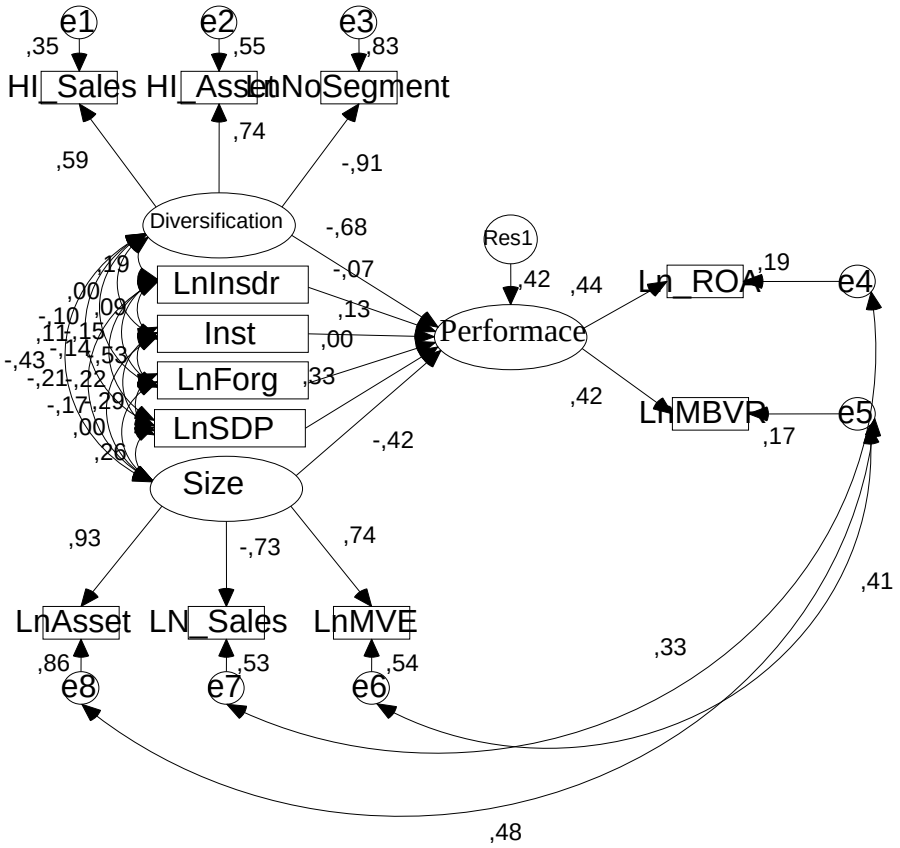

Figure 3: The structural model of company performance

For a country like Indonesia, the insignificant result might be due to different political, social, regulatory framework and internal control systems as compared to developed capital markets. Specifically, there is concentration ownership by founder family which probably causes an affiliation relationship among owners, board of commissioners and directors (Herwidayatmo, 2000) in such a way that insiders shareholding may not affect company performance. In developed markets, a

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company's governance structure allows the board of commissioners directly to supervise the board of directors (Arifin, 2005). The board of commissioners has the authority to appoint and dismiss the board of directors. The position of board of commissioners in this contex is relatively strong against the directors so that control over management activities can be carried out effectively. This is in contrast to Indonesia. The rules of limited corporation (Undang-undang Perseroan Terbatas, 1995) states that the member of the board of directors is appointed and dismissed by the general meeting of shareholders –GMS (clause 80, subsection 1 and clause 91, subsection 1) (Setneg, 1995) Similarly, the member of the board of commissioners shall be appointed and dismissed by the GMS (clause 95, subsection 1 and clause, 102 subsection 1). In brief, the board of commissioners and the board of directors are of equal position in the company's governance structure in Indonesia. They are directly responsible to the general meeting of shareholders. Hence, the board of commissioners could not control the directors such as applied in the developed countries. This might be one of the reasons why insider ownership did not influence performance of listed companies on IDX. Although better rules and regulations, and stricter enforcements of these, should reduce agency conflict across the board and improve corporate performance, this thesis examiner claimed that it is rather difficult to conceive wether or how, these changes may improve the impact of ownership structure aspects (e.g., insider ownership) on company performance.

8.2 Institutional ownership is related to company performance.

This study reveals that institutional ownership had an insignificant and negative influence on company performance with p-value of 0.39, which was more than 0.05. It shows that institutional ownership was not an effective monitoring agent to mitigate agency conflict. Although institutional investors had a large number of company shares, they could not discipline the managers to increase company performance. Hence, Hypothesis 1b was not supported as institutional investors were not effective monitoring agents for listed companies on IDX. Although institutional investors in Indonesia held an average of 36.43% of company shares with a maximum value of 97.89%, they were unable to mitigate agency conflicts. This result is consistent with the findings of Kumar (2005), Li et al. (2006), and Zeitun and Tian (2007). They found that institutional investors could not influence company performance. Similarly, in Japan, large shareholders such as institutional investors are passive shareholders; however, bank ownership has a significant effect on company performance (Kang & Shivdasani, 1995).

Moreover, the finding of this study shows a negative relationship between institutional investors and company performance which did not support some of the previous studies that institutional investors had influence on company performance such as in the work of Agrawal and Mandelker (1987), Baysinger and Hokisson (1990), McConnel and Servaess (1990), and Morck et al. (1988). Their results showed that large shareholders such as institutional investors had a higher motivation to seek information and monitor managers in order to reduce agency costs (Shleifer & Vishny, 1986). It also revealed that institutional investors as monitoring agents could work in the U.S. and U.K. but this did not seem occur in Indonesia.

8.3 Foreign ownership is related to company performance

This study rejected Hypothesis 1c since foreign ownership had a positive and insignificant effect on company performance (p-value = 0.99 > 0.05). The finding in developed markets contradicts the result in a developing market such as IDX. The argument that foreign investors have more experience and expertise to control agency problem in a company (Khanna & Palepu, 1999) where they have more company shares and can exert their rights to discipline managers in increasing

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company performance, could not be supported. Foreign investors were not an effective monitoring agent in IDX. This might be because they do not understand how the market works and the culture of Indonesia. This finding is in line with those of Kumar (2005), and Zeitun and Tian (2007), who found that foreign ownership did not have a significant impact on company performance. Foreign investors could not provide a valuable monitoring function in reducing agency conflict in listed companies on IDX. This result is therefore inconsistent with the works of Chibber and Majumdar (1989, 1998), Khanna and Palepu (1999), and Douma, George and Kabir (2002) as cited in Kumar (2005).

8.4 Shareholder dispersion is related to company performance.

Shareholder dispersion influenced company performance since its coefficient was statistically significant. Thus, Hypothesis 1d was accepted. The argument by Maher and Anderson (1999) as cited in Yet and Guan (2005) that concentrated ownership could cause misallocation of funds and dispersion of ownership structure might promote capital market through easy entry and exit, could be supported. Furthermore, dispersed ownership as a monitoring mechanism to reduce misallocation of funds that could in turn affect company performance (Fama & Jensen, 1983; Short et al., 2002), could work for companies listed on IDX. Hence, in this context, greater dispersed ownership may result in an increase of company performance.

Dispersed ownership had been significant in influencing company performance, the positive sign that was found in this study would mean greater public ownership led to more dispersed shareholders, and thus increased company performance since the public investors would be monitoring agent. Shareholder dispersion appear to successfully control managers, and thus could increase company performance on IDX.

8.5 Diversification of business is related to company performance.

Based on the result of this study, diversification of business also significantly and negatively affected company performance since its p value of 0.02 was less than 0.05. In brief, Hypothesis 2 was supported. This study did not support the internal capital market hypothesis (Lins & Servaes, 2002), which refers to the division with high cash flows contributing to the division with low cash flows to enhance company value. Internal capital market as a source of funding did not seem be a factor among diversified companies to boast performance in IDX. This study indicated that diversification reduced the company performance in IDX since the companies could not reap benefits of diversification such as economies of scale, and easier access to funds; hence, company performance would increase. This finding did not support Khanna and Palepu (1997) in that through diversification, companies in emerging market could get additional fund from internal capital market and share the expertise. Diversification had a negative significant effect on company performance in IDX since greater diversification results in greater agency cost and reduced performance

8.6 Company size is related to company performance

The company size was found to be statistically significant effect on company perormance. It could influence company performance at 0.01 level of significance. Hence, Hypothesis 3 was accepted. The result shows a negative coefficient between company size and company performance, which reflected that larger company size would decrese company performance. This finding indicates that listed companies on IDX could not reap benefits of company size such as economies of scale, skilled managers, and greater specialization, which could probably reduce transaction costs, which in turn

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caused an increase of company performance (Driffield et al., 2007; Gupta, 1969; Lang & Stultz, 1994; Smith & Watts, 1992). A large company is associated with being difficult for investor to monitor the manager , hence agency cost increases and reduce company performance. This result is not consistent with previous evidence that company size has a positive and significant effect on company performance (Chakrabarti et al., 2007; Chen & Ho, 2000; Kumar, 2005; Mickkelson et al., 1997; Ming & Gee, 2008; Serrano-Cinca et al., 2007; Zeitun & Tian, 2007). This study indicated that Investors associate company size with greater agency conflict as stated in the agency theory where it is rather difficult for shareholders to monitor top management of a large company. The summarizes of hypothesis was descripes in Table 9.

Table 9: Summarizes of the hypothesis testing

H	Exogenous Variable	Endogenous Variable	Std. Estimate	S.E	C.R	p	Supported
1a	Insider Ownership	Company prformance	-0.001	0.001	-0.585	0.558	*No*
1b	Institutional ownership	Company prformance	0.018	0.018	0.846	0.397	*No*
1c	Foreign ownership	Company prformance	0.004	0.004	0.002	0.998	*No*
1d	Shareholder dispersion	Company prformance	0.005	0.005	2.178	0.029	*Yes*
2	Diversification of business	Company prformance	-0.123	0.035	-3.502	0.022	*Yes*
3	Company size	Company prformance	-0.008	0.003	-2.288	0.000	*Yes*
Squared multiple correlations (SMC) for company performance: 0.42							

Note. C.R: Critical Ratio; P: Probability; H: Hypothesis; SE: Standard Error; Std: Standardized

The structural model output also showed that *R*-square or SMC for endogenous variable was 0.42. Exogenous variables (ownership structure, diversification of business and company size) could explain 42% of the variance in company performance. There are other variables that were not accounted for in this study that could explain 58% of the variation in company performance.

9. Conclusion and Future Recommendation

This study showed that insider ownerhip, institutional ownership and foreign ownership have significant influence on company performance while shareholder dispersion significantly affected compny performance. This means that the only shareholder dispersion could be monitoring agent to increase company performance in IDX. Diversification of business and company size have negative and significant effect on company performance. Future research is suggested to use more variables since the SMC in this study only 42%.

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