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Independent directors and profitability: Evidence from Indonesia

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Abstract

The primary response to this issue was to introduce and strengthen the role of independent directors in the board of directors. Independent directors aim to improve the quality of corporate governance by ensuring adequate management supervision so that stakeholders and shareholders can be well looked after. This article examines independent directors' influence on company profitability in Indonesia. The data used in this research comes from 90 companies in Indonesia from 2013 to 2022. We use panel data regression analysis as a method to measure the influence of independent directors on profitability. We find that independent directors have a significant favorable influence on company profitability. These findings support the hypothesis that the presence of independent directors can improve company performance through effective monitoring and objective decision-making. In addition, these results show that good corporate governance practices, namely practices involving independent directors, are an essential factor in increasing company profitability in Indonesia.

Keywords: Independent directors; profitability; supervision; good corporate governance

1. Introduction

In the 20th century, precisely after accounting irregularities occurred in the United States and Western countries, regulators worldwide became active in enacting various laws and guidelines (Mishra, 2020). One of the primary responses to this issue has been to introduce and strengthen the role of independent directors in board direction. In addition, several cases show that managers tend to hide bad news from the market, which triggers the risk of a sudden crash when the bad news is released to the market (Hutton *et al.*, 2009). Independent directors can increase information transparency, reducing the risk of losses (Kang *et al.*, 2020). The main objective of independent directors is to improve the quality of corporate governance by ensuring adequate management supervision so that the interests of shareholders and other stakeholders can be adequately safeguarded. Independent directors are expected to prevent conflicts of interest and unethical business practices and assist companies in adopting internationally recognized best practices (Le *et al.*, 2022).

In Indonesia, the role of independent directors has been regulated explicitly by various regulations and policies issued by relevant authorities, such as the financial service authority *(Otoritas Jasa Keuangan-OJK*). Based on OJK regulation No. 33/POJK.04/2014 on the Board of Directors and Board of Commissioners of Issuers or Public Companies, public companies must have at least 30% of the total members of the Board of Commissioners as independent directors. This policy aims to ensure that there is adequate oversight of management performance, as well as to encourage more transparent and accountable corporate governance practices. In addition, independent directors in Indonesia must also fulfill various independence criteria, such as having no financial, shareholding, or family relationships with the controlling shareholder or other board members.

The curious thing in Indonesia is that, in contrast to most developed countries that use a one-tier board system (where non-executive directors oversee executive directors), Indonesia applies a two-tier board system, with the board of commissioners in charge of overseeing the board of directors

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(Atmaja and Hidayat, 2021). Using the Indonesian object, we will observe whether a two-tier board structure can provide more effective managerial and supervisory mechanisms, thereby reducing the exploitation of minority shareholders and increasing corporate profitability. Moreover, the top priority of corporate governance in developing countries such as Indonesia is to protect minority shareholders from exploitation (Mishra, 2020). This is caused by the fact that family business groups still dominate many corporate assets. Thus, agency problems between majority and minority shareholders are more contrasted. The presence of independent directors who have nothing to do with the company's business family will be able to prevent deviations in business practices.

Corporate profitability in Indonesia varies depending on the industry sector, company size, and macroeconomic conditions affecting domestic and international markets (Suteja *et al.,* 2023). It is indicated that market changes, government policies, global markets, and exchange rate fluctuations can influence the profitability of companies in Indonesia. It is indicated that exchange rate fluctuations, changes in government policy, and global market dynamics. In recent times, a company's focus has been to streamline operational activities and business innovation to encourage increased company profitability. Another essential factor for improving company performance is implementing digitalization and activating technology in various sectors (Dharmayanti *et al.,* 2023).

The intensity of the presence of independent directors can significantly influence the increase or decrease in company profitability. Transparency and efficiency can produce good governance for the company, so the role of independent directors in this matter can increase the company's profitability (Le *et al.*, 2022). Independent directors have the impact of a more objective view and can freely challenge management decisions that may not be in line with shareholder interests (Jin *et al.*, 2022). In this research, we can show evidence that the high role of good independent directors in the company can improve financial performance due to better supervision and governance (Moscariello *et al.*, 2019; Shan, 2019; Wang *et al.*, 2015). However, a negative impact is also possible if independent directors must deeply understand the company's business or spend too much time meeting compliance requirements rather than focusing on business strategies that can improve profitability (Adams and Jiang, 2016; Persons, 2006).

Several studies have examined this. Strong independent directors can improve shareholder valuation as they can deter value-destroying decisions such as unhealthy merger bids, excessive free cash flow retention, retention of problematic CEOs, aggressive earnings manipulation, and CEO pay that is unrelated to performance (Fogel *et al.*, 2021; Wang *et al.,* 2015). Adequate representation of independent directors can also improve the company's performance, thereby increasing profitability (Fogel *et al.,* 2021). A negative relationship was also found in Mishra (2020), which states that companies recruit several independent directors only to fulfill regulatory norms with little focus on their quality. Meanwhile, Bhagat and Bolton (2008) found no relationship between company performance and board independence.

The inconsistencies in previous studies create room for further investigation. Most previous studies focus on developed markets such as the United States and Europe, where corporate governance structures and capital market regulations differ from conditions in Indonesia. Differences in culture, regulations, and market dynamics create the need for a more in-depth and specific investigation into the influence of independent directors on Indonesia's profitability. This research aims to complement this by providing more comprehensive empirical evidence regarding the role of independent directors in increasing or decreasing company profitability in Indonesia.

2. Literature review

Independent directors are important in corporate governance worldwide, including in Indonesia. Strict regulations govern the presence of independent directors. The concept of independent directors emerged as a response to corporate scandals and failures, aiming to improve board oversight and independence of decision-making (Mishra, 2020). Independent directors are better known in Indonesia, which adheres to the Two-Tier System of corporate law, which in the Two-Tier System has two boards of directors consisting of executive directors and non-executive directors (Atmaja and Hidayat, 2021). Executive directors need to observe value within the company, while non-executives need to exercise their influence by behaving in ways that incorporate understanding, insight, and skills for the company (ACA Global, 2012). The concept of Independent Director was first recognized and affirmed in the letter of *Surat Edaran Bursa Efek Indonesia* (BEI) Nomor: SE-00001/BEI/02-2014

regarding Explanation of the Term of Office of Independent Commissioners and Independent Directors of Listed Companies (Supriatna and Ermond, 2019). Strict rules and regulations are expected to create diverse expertise and perspectives in board deliberations, oversee executive actions, and safeguard shareholder interests (Mishra, 2020). Independent directors' inclusion and effective functioning are critical to fostering corporate governance practices that build stakeholder trust.

Agency theory

From an agency theory perspective, many researchers observe that the supervisory role of independent directors is critical in reducing potential conflicts of interest between managers and shareholders, thus ensuring managers' interests are in line with those of shareholders (Jensen and Meckling, 1976; Le *et al.*, 2022; Mishra, 2020). An essential mechanism of this theory is the supervision carried out by management by-election, namely selecting independent non-executive directors and dividing the chairman and CEO roles (Mishra, 2020). Independent non-executive directors function as supervisors with nothing to do with the company's daily operational activities. It can reduce interest risks because independent directors can provide an objective view of the company (Guping *et al.*, 2020). Next, we turn to the division of the chairman and CEO roles. It is done to limit power that only focuses on one individual. The purpose of dividing the roles of chairman and CEO is to address abuse of power, thereby reducing the risk of abuse. That way, management performance in a company can increase effectively. Corporate performance is often linked to this practice because it is assumed that the board will focus more on supervisory and strategic functions. At the same time, the CEO can focus more on his duties in carrying out the company's daily activities (Chandren *et al.*, 2021).

Agency theory is a source of good corporate governance because this theory discusses the conflict between shareholders and company management (Usman *et al.*, 2021). Implementing GCG is essential to ensure that shareholders' interests are protected and management actions are aligned with maximizing shareholder value. The corporate governance framework in Indonesia is based on the principles of transparency, accountability, responsibility, independence, fairness, and equality (KNKG, 2006). Based on OJK Board of Commissioners Decree No.1/KDK.01/2013, The role of the *Otoritas Jasa Keuangan* (OJK) in strengthening corporate governance is by developing a roadmap to improve the performance of public companies in particular and Indonesian companies in general (Otoritas Jasa Keuangan, 2013).

On the other hand, the Indonesia Stock Exchange (IDX) acts as an institution that makes guidelines for Indonesian corporate governance with the aim of (1) supervisory and advisory guidelines, (2) guidelines on morals, regulations, articles of association, and business ethics; and (3) guidelines for GCG principles in daily company activities (Bursa Efek Indonesia, 2011). These efforts are critical in building investor confidence and fostering a business environment conducive to sustainable economic growth. The alignment of GCG practices with agency theory, supported by a strong institutional framework, is critical in addressing the risks Indonesian companies face.

The role of an independent director

From a management perspective, independent directors influence critical decisions, including strategic planning and performance evaluation (Boivie *et al.*, 2021; García-Ramos and Díaz, 2021). Furthermore, regulations and industry requirements for companies cannot be ignored; apart from that, the role of risk management is also essential in identifying, assessing, and mitigating anything that has the potential to generate risk (Chintrakarn *et al.*, 2021). Financial report monitoring activities, financial transparency, and the integrity of company financial reports are essential duties of independent company directors (Hasan *et al.*, 2020). It is done to prevent irregularities in financial reporting so that investors can have more confidence in the company. Another role of independent directors is to emphasize fair treatment of all shareholders, both minority and majority, as well as ensure harmony between executives and company performance (Jin *et al.*, 2022). Some of these roles are a form of contribution from independent directors in maintaining stakeholder trust. In this way, the presence of independent directors can have a positive impact on corporate governance and maintain the company's long-term goals to remain consistent.

Independent director and profitability

Independent directors can reduce agency costs, increase market value, and reduce the potential for internal control by the company itself Bhagat and Bolton (2013), Moscariello *et al.* (2019), Shan (2019) revealed that companies that have more independent directors will have the potential for better performance compared to companies that have fewer independent directors. This situation proves that independent directors can influence increased supervision and objectivity in decision-making, increase investor confidence, and improve the company's performance better in the future (Guping *et al.*, 2020; Hasan *et al.*, 2020).

Research conducted by Pasko *et al.* (2021) found that a board that can direct activities will be more effective in implementing management control. The direction referred to is the ability to provide information and creative ideas to improve company performance (Alqatan *et al.*, 2019). According to Sanjaya and Setiawan research (2023) , high independent directors will practice good earnings management in the Indonesian region. Sanjaya and Setiawan research (2023) also explains that an increase in accounting engineering practices will improve financial statement quality, making it easier for investors to use information in their decision-making process. Thus, independent directors are needed to supervise these practices. Overall, empirical evidence from various studies suggests that independent directors play an important role in strengthening good corporate governance, which leads to increased corporate profitability, firm value, and improved overall corporate performance.

3. Method

Data and variable

We use annual data from 2013 to 2022 for companies in Indonesia. Thomson Reuters Database provides all data and partially processed by the author based on the financial statements of the companies concerned. The required independent variable is the return on assets as a proxy for profitability. The dependent variable is the percentage of independent directors from the total number of board directors. The control variables used are firm age and the logarithm of total assets. At the same time, the return on sales variable is used for the robbery test. Details can be seen in Table 1 below.

Table 1. Variable of Research

Variable	Formula/Description	Sources(s)
Dependent Variable		
ROA (Return on assets)	Net income/total assets	Thomson Reuters, author calculation
ROS (Return on solvability)	Net income/revenue	Thomson Reuters, author calculation
Independent Variable		
IND (Independent director)	The percentage of independent directors out of the total number of directors.	Thomson Reuters, author calculation
Control Variable		
FA (Firm age)	Age of company	Thomson Reuters, author calculation
LogTA (Firm size)	logarithm of total assets	Thomson Reuters, author calculation

Econometrics modelling

We created the following equation to analyze the impact of independent directors on the profitability of companies in Indonesia.

$$Profitability_{it} = \alpha_i + \beta_1 IND_{it} + \varphi X_{it} + \varepsilon_{it} \quad ...(1)$$

Where i and t represent the company index and year, respectively, ROA is a proxy to measure the company's return on assets, which expresses profitability (Fajarwati and Witiastuti, 2022; Le *et al.*, 2022; Mishra, 2020; Tam *et al.*, 2021). The more positive the rate of return on assets, the greater the company's profitability, and vice versa. In this measurement, we only use ROA to measure the company's profitability because it provides a more direct and comprehensive picture of its efficiency in managing its assets to generate profits.

INDP2 is a measurement used to see the percentage of independent directors from the total number of directors (Fajarwati and Witiastuti, 2022; Mishra, 2020; Tam *et al.*, 2021). This indicator shows that enough independent directors can help ensure that management decisions are taken objectively. Thus, we assume that the high number of independent directors will lead to a high-profit level for a company.

X is a vector of bank-level control variables. We use two variables, namely FA and LogTA. Each variable is measured as the firm's age and the logarithm of total assets. These two variables are used as control variables of this study. Firm age is the number of firms from the establishment to 2022. While LogTA is the logarithm of total assets. Total Asset is logarithmized to reduce data skewness so that the data distribution is closer to normal and statistical analysis becomes more valid and reliable. We use these two variables as controls because they can affect the level of efficiency and performance of the company in the context of company competition, so it is important to control these variables to make the analysis more accurate.

Model estimator

We use the fixed effect model to estimate equation (1). The fixed effects model in this regression analysis is useful for controlling the fixed effects of observation units that do not change over time, such as differences between firms that do not change over time. We use this to obtain more consistent estimates and identify the causal relationship between the observed variables.

4. Results and discussion

Descriptive statistics

Statistical descriptions contain summarized data in a more structured and easier-to-understand form. This statistical description aims to provide an overview of the observed data's distribution, patterns, and characteristics. Statistical description methods include measures of central tendency such as the number of observations, mean, standard deviation, minimum, and maximum of the data. Thus, statistical descriptions help authors and readers to comprehensively understand and describe the data before conducting further analysis or making conclusions.

Table 2. Descriptive statistics

Variable	Obs	Mean	Std. Dev.	Min	Max
ROA	851	0.056	0.11	-1.126	0.583
ROS	847	0.011	2.001	-55.031	2.08
IND	491	2.752	1.23	0.715	11.334
FA	832	34.547	16.61	1	89
LogTA	851	21.251	1.77	16.159	25.575

Based on the data we obtained, there are 90 companies in Indonesia. From these 90 companies, we summarize in Table 2 to see the extent of the description of the data we get. The observation values from our results show various numbers among the variables. This shows that our data is incomplete, so there are large and small observations. The average value of ROA is 0.056 or 5.6%, with a standard deviation of 0.11. This result indicates that the average rate of return of companies in Indonesia is quite good. The minimum and maximum values are -1.126 and 0.583, respectively. Switch to the INDP2 variable, which describes the proxy for independent directors. The average of the INDP2 variable is 2.752, with a standard deviation of 1.23.

The distance from the minimum and maximum values is 0.715 and 11.334, respectively. Turning to the control variables, the first is FA, with an average level of 34.547, a standard deviation of 16.61, and a minimum to a maximum of 1 to 89. This indicates that the average age of companies in Indonesia is 35 years, the youngest is one year, and the oldest is 89. Second, LogTA has an average value of 21,251 with a standard deviation level of 1.77. While the minimum is 16.159 and the maximum is 25.575. It shows that most companies have a total asset size around the average value. The ROS variable is the variable we use when robustness testing. This variable has an average value of 0.011 with a standard deviation 2.001. At the same time, the distance from the minimum and maximum values

is quite large, which is -55.031 and 2.08, respectively. This variable shows that the average return on sales of companies in Indonesia is 1 percent.

Regression results

We use regression analysis to see the influence between the independent and dependent variables. It aims to assess how strong the influence is between the variables and to be able to explain the dependent variable based on the observed independent variables. Using a fixed effects model in our regression analysis allows us to control for the fixed effects of those variables that do not change, thus allowing for a more accurate evaluation of the effects of the independent variables on the dependent variable (Dettori *et al.*, 2022). Thus, using a fixed effect model helps reduce the bias due to unobserved fixed differences among the observation units.

Table 3. Regression results with fixed effect(fe) model

	(1) ROA	(2) ROA	(3) ROA
INDP2	0.00973**		0.0105***
	(2.40)		(2.61)
FA		-0.00353***	-0.00306**
		(-3.52)	(-2.24)
LogTA		0.0173**	-0.00633
		(2.20)	(-0.42)
Constant	0.0456***	-0.185	0.295
	(3.98)	(-1.25)	(0.99)
Number obs.	491	823	485
Number firms	85	86	81
R-seq within	0.0140	0.0166	0.0411

Note: *, **, and *** denote significance in 10%, 5%, and 1%, respectively.

We regress ROA against INDP2 and control variables (FA and LogTA). Our results in Table 2 show that the results have a significant positive effect. Regression (1) ROA shows the regression we tested based on the ROA variable with INDP2 only. The results show a positive effect, with a significance level of 0.05. Then, we regress the ROA variable with the selected control variable (the result of regression (2) ROA). The results obtained from the effect of control variables show that FA (Firm Age) has a negative effect with a significance level of 0.01.

In contrast, the LogTA control variable has a significant positive effect of 0.05. In regression (3) ROA, we regress INDP2 along with its control variables so that the results obtained from the INDP2 variable on ROA are still consistent, positive, and significant. The significance level result is also stronger, 0.01.

Robustness test

Robustness testing is a method used to ensure the consistency of research results when various assumptions or conditions are changed. It aims to assess whether the study's main findings remain valid and are not significantly affected by variations in the model, analysis methods, or data used. By conducting a robustness test, researchers can strengthen the argument that research results are independent of certain specific factors and are more likely to reflect the true relationship in the data. Based on this study, we use robustness tests in two ways. The first is a regression test with a random effect model, and the second is a robustness test using a profitability variable proxied by return on sales.

Random effect (re) model

The random effect model tests the consistency and reliability of the fixed effect estimation results. It assumes that the confounding variables are uncorrelated with the independent variables and allows for variation between observation units that the fixed effect model does not explain. Thus, this model can take into account the heterogeneity that exists among observation units. In addition, the

robustness test with the random effect model also makes it possible to generalize the research results to a wider population.

The robustness test results on the random effect model produce consistent results. It can be seen in Table 4 that the random effect (1) ROA gets positive results with a significance level of 0.05. The control variable is added in the random effect (2) ROA. Meanwhile, the random effect (3) ROA still produces the same effect, which is positive and significant. This means that even though the effect test is carried out using other estimation models, the results are still robust.

Table 4. Robustness with random effect (re) model

	(1)	(2)	(3)
	ROA	ROA	ROA
INDP2	0.00729**		0.00877**
	(1.98)		(2.34)
FA		-0.000508	-0.000973
		(-1.09)	(-1.61)
LogTA		-0.000540	-0.00966
		(-0.13)	(-1.47)
_cons	0.0394***	0.0882	0.284**
	(2.63)	(1.07)	(2.10)
N	491	823	485
N_g	85	86	81
r2_w	0.0140	0.00842	0.0364

Note: *, **, and *** denote significance in 10%, 5%, and 1%, respectively.

Return on sales (ROS)

A robustness test is conducted by changing the dependent variable from Return on Assets (ROA) to Return on Sales (ROS) to ensure that the research results are not dependent on one particular performance measure. The ROS variable is used instead of the ROA-dependent variable to evaluate whether the previous findings remain consistent. The results are the same if the profitability variable is measured using other proxies.

Table 5. Robustness Independent with ROS

	(1)	(2)	(3)
	ROS	ROS	ROS
INDP2	0.381**		0.374**
	(2.08)		(2.02)
FA		0.0203	0.0527
		(0.67)	(0.84)
LogTA		-0.0397	-0.160
		(-0.16)	(-0.23)
_cons	-1.036**	0.185	0.583
	(-2.00)	(0.04)	(0.04)
N	491	819	485
N_g	85	86	81
r2_w	0.0105	0.000756	0.0127

Note: *, **, and *** denote significance in 10%, 5%, and 1%, respectively.

It can be seen in Table 5, which shows that in regression (1) ROS, the result is significantly positive. Next, we used the ROS regression model (2) to test the effect of the control variable. Finally, we entered the (3) ROS model, which included the independent and control variables tested simultaneously. The regression results still show consistency, i.e., a significant positive.

Discussion

These results illustrate that a high level of independent directors will result in profits for the company. First, independent directors can add insight and consider diverse experiences in strategic company decisions (Le *et al.*, 2022). The decisions used by independent directors in evaluating business strategies and risks are more objective. It can reduce the potential for decision-making based on distorted personal or group interests. Second, independent directors with good competence can supervise the company more transparently and accountable so that corporate governance runs well (Jin *et al.*, 2022). The impact resulting from this process can increase market confidence in the company. That way, access to company funding will be easier to obtain. Third, the activeness of independent directors in optimizing internal monitoring, operational efficiency, and costs can produce effective company activities (Mishra, 2020). Therefore, we state in this research that companies with a high level of independent directors will significantly impact company profitability through improved decision-making, effective risk management, and increased market confidence.

This research has results that align with agency theory in the literature review. Agency theory emphasizes the importance of strengthening management supervision so that actions taken align with shareholders' interests to improve overall performance (Jensen and Meckling, 1976). In addition, the results are supported by research conducted by (Dharmadasa *et al.*, 2014; Nguyen *et al.*, 2015; Peng, 2004). This positive influence also aligns with expert opinions, resource dependency theory, and agency theory, which explains increased performance through independent directors (Dharmadasa *et al.*, 2014). In addition, in the Indonesian region, these results provide a strong argument for the importance of regulations set by the Financial Services Authority (*Otoritas Jasa Keuangan-OJK*) and the Indonesian Stock Exchange (*Bursa Efek Indonesia-BEI*) because they can determine the quality of independent directors in companies in Indonesia.

5. Conclusion

The results of our research provide strong evidence that independent directors have a positive influence on company profitability. Several control variables, such as company age and the logarithm of total assets, are included, and the regression results still show the same results, namely that independent directors have a positive influence with a more substantial level of significance. We use a robustness test with a random effect model and test other profitability proxies, namely ROS (return on sales). The results also show similar consistency after being robust. This research illustrates that the increase influences the quality of corporate governance in independent directors. These results are consistent with agency theory, which emphasizes the importance of supervision in a company's management process. Our findings also provide confidence that consistent regulations from the Financial Services Authority (*Otoritas Jasa Keuangan-OJK*) and the Indonesian Stock Exchange (*Bursa Efek Indonesia-BEI*) have a very important impact on the implementation of company management.

Our research also has implications for corporate management, shareholders, and regulators. For management, it is necessary to select quality independent directors so that the company's performance can run well, optimizing profitability growth. Shareholders can maximize their role by encouraging companies to strengthen governance by optimizing the number of competent, independent directors so that decision-making is more strategic. Regulators such as the Financial Services Authority (*Otoritas Jasa Keuangan-OJK*) and the Indonesian Stock Exchange (*Bursa Efek Indonesia-BEI*) can play a role in enforcing policies regulating the presence of independent directors on company boards. Consistent implementation of policies can positively impact the company in the future.

This study has several limitations that may be considered in future research. First, our research does not consider categories of independent directors such as knowledge, expertise, legitimacy, and social connections in increasing company profitability (Hillman *et al.*, (2002). Second, our research does not consider the effects of negative information on some companies, such as information cases related to legal or other abuse, which can significantly impact company performance and market perceptions of corporate governance. Third, our research does not categorize companies that are State-Owned Enterprises (*Badan Usaha Milik Negara-BUMN*) or private companies due to the dynamics of governance and regulations. It may vary according to company category.

For further research, it is recommended to consider other proxies in measuring company profitability, such as Return on Equity (ROE), Net Profit Margin (NPM), Gross Profit Margin (GPM),

or others. In addition, further research can add moderating or mediating variables, such as institutional quality, audit factors, or ownership structure. This way, the results can strengthen a deeper understanding of the mechanisms underlying the relationship between independent directors and company profitability. Apart from that, to provide more detailed results, further research can also compare companies categorized as state-owned and private.

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