Chinese Business Review, ISSN 1537-1506
February 2012, Vol. 11, No. 2, 224-232

Family Ownership Type and the International Involvement of SMEs: Empirical Study of Agency Theory in East Java Indonesia

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This paper briefly draws the dimension of small, micro and medium enterprises' (SMEs) behavior in terms of internationalization strategy based on the ownership structure among SMEs in East Java. The finding is very interesting when there is no ownership structure variation, so the decision to choose international involvement could not be supported. Also, the scale determination is not becoming constraint of SMEs in East Java to involve internationally, especially thought export strategy. However, several aspects are considered to control the export behavioral dimension which is research and development (R&D) and sales, significantly. The result shows that there still are other elements except ownership type could impact internationalization strategy choices of SMEs in East Java.

Keywords: internationalization, corporate governance, agency theory, SMEs

Introduction

The contribution of SMEs in labor absorption in Indonesia reach 85 million or 96.18 percent and the contribution to the gross domestic product reach 53.28 percent (KOMPAS, December 14 2007). This contribution is a reflection of adaptive and flexibility of SMEs to face business competition in the same time with market liberalization that opens opportunity of SMEs to adopt internationalization strategy. Several studies conduct by Bonaccorsi (1992), Knight (2001), Lu and Beamish (2001) indicate business size is not boundaries to global competition. However, the needs to identify factors that make SMEs difficult to get market access internationally.

This study focuses on the impact of type of family ownership to the international involvement of SMEs which aims at their competition strategic choices. The ownership types become an interesting issue, especially it determines business strategy related to the degree of risk aversion (Thomsen & Pedersen, 2000) and the firm's resources endowment (Shrader & Simon, 1997). Moreover, based on the agency theory, ownership concentration has a relevancy toward the monitoring cost mechanism which involves shareholders and ends up with ownership

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structure decision as business unit.

The analysis of the relationship between ownership type and strategic behavior has not been well researched. Ownership type of SMEs as well as corporate ownership can influence enterprises to decide their access to financial, technological adopted in terms of innovation or commercial resources and capabilities (Allen & Phillips, 2000). The type of ownerships categorizes as family blockholders, corporation, and combination of families and corporation with some percentage owned by corporation. The ownership types determine the degree of SMEs' involvement internationally. In other words, it shows the degree of SMEs' tolerance to the risk that influences their decision in getting financial access non-conservative or traditionally, innovation of product or services and strategy to survive with endowment resources such as raw materials and their capabilities or capacities.

Generally, this research conducted to contribute to develop corporate governance of SMEs that in turn strengthen institutions of SMEs to compete internationally. The implication is competition strategy through SMEs in East Java. In addition, this research analyses using model conducted by previous research by Fernandez and Nieto (2006), the influence of ownership type to improve our knowledge of the internationalization of SMEs. This research can expand to SMEs in Indonesia with attention to their uniqueness and culture differences for every region.

Theoretical Framework and Hypothesis

Internationalization Strategy

Indonesia governance declared 2005 as a micro-finance year as same as poverty reduction action program through empowering SMEs. However, since this declaration, the problems face by SMEs have still classical problems such as funding access, weak market network, lack of idea or innovation to development product, lack of legal aspects include business permit, and lack of market information (KOMPAS, February 29, 2008).

These constrains can be threats to the SMEs to compete broadly. One of these strategies is internationalization strategy. Conceptually and theoretically, there are two approaches of internationalization theories which are internalization theory (Bucley & Casson, 1976) and eclectic theory (Dunning, 1977, 1981). Internalization theory arises when big enterprises developed in 1970s era that threats the existence of SMEs. In progress, this theory tries to integrate the beneficial from the internalization, localization, and ownership.

Internationalization process can be seen as a learning process of SMEs. Several aspects of internationalization such as age, size, and industry sector choices of SMEs have been discoursed among researchers in other countries (Fernandez & Nieto, 2006). Also, internationalization strategy of SMEs should give attention to the behavior of owner in order to determine their achievement or their degree of risk avoidance of SMEs. This discussion is being the new element of consideration to conduct internationalization strategy with relevancy to the type of ownership.

Ecletic theory particularly stresses the possession of intangible resources (Dunning, 1981) and SMEs' knowledge on international market and networks to their products. Underlining this theory is sustainability of resource endowment that makes motivation to go international is stronger. Those factors, both motivation and resource endowment have an impact on the strategy adopted by SMEs. The internationalization decision will shape corporate governance mechanism between parties related with this decision. Trust, knowledge sharing, and contract-basis relationship (Snkovics, Cavusgil, & Roath, 2007) are three alternatives of corporate governance in export channel. As increase the potency of SMEs to be strengthen as good as performance can be reached by SMEs.

Agency Theory and Corporate Governance

Jensen and Meckling (1976) developed agency theory which management as an agent of shareholders. Shareholders expected that agent acted base on shareholders' interests, so they can delegate their authorities to manager. To doing their function well, management should be compensated and monitored properly. Monitoring activities need costs called agency costs. Agency costs arise when the interest of the managers are not aligned with those the owners and take form of preference for the job perks, shrinking, and making self interested and entrenched decisions that reduce shareholder wealth (Ang et al., 2000). The magnitude of these costs is limited by how well the owners and delegated third parties, such as banks, monitor the actions of the outside managers.

Moreover, there are two mechanisms to reduce management's chance to take a disadvantage action to outside investors, monitoring and bonding. Both activities in one side can alleviate the potential problems rise by manager, so the value of the firm keep remains increase. But, on the other hand, both of them can create cost of monitoring that potentially decreases value of the firm. Agency theory in case of family as sole owner may not be able to monitor perfectly the firm performance for some reasons such as no separation between manager and owner, except he or she hired an outside manager. Consequently, agency problem in case family blockowners incur a zero agency cost base case. More specifically, this kind of case is more focused on family prosperity and family identity. So, if there is agency problem the owner is difficult to monitor because of no separation role between owner and manager (Davis, Schroorman, & Donaldson, 1997; Shleifer & Vishny, 1997).

Investment decision in family blockowners is based on differences of interest in between firm and family interest (Coombes & Watson, 2001, p. 5; as cited in Luo et al., 2009). Practically, it indicates that from the perspective of strategic behavioral to decide export, several studies based on agency theory have examined two types of issues: first, managers' level of participation—an important factor in establishing an adequate incentive system; second, the effect of concentrating ownership in the hands of non-managerial shareholders with sufficient incentives and information to control the firm's operation (Wright, Feris, Sarin, & Awasthi, 1996; Gillan & Stark, 2000; Gorton & Schmid, 2000). In other words, corporate governance, type of ownership and strategic behavioral to make an internationalization strategy decision are related to the monitoring cost, institutional logic, independency of ownership and symmetric knowledge.

Agency Problem Among Small Business

Small businesses come closest to the type of firm depicted in the stylized theoretically model of agency costs developed by Jensen and Meckling (1976). In small business, the ownership and management structures are firms whose managers own 100 percent of the firm. These firm, have no agency costs, by definition. On the other hand, firms hire an outsider to manage the business who may not be able to monitor perfectly for the reasons such as lack of time or ability. Owners of SMEs typically lack of financial sophistication, lack of performing audits or understanding the operating or financial results possible incur residual agency costs.

No agency costs in small firms owned by family or sole ownership also supported by Jensen and Meckling (1976) and Fama and Jensen (1983). Moreover, another study by Ang et al. (2000) sums up that agency costs are higher when outsider manages the firm and vary inversely with the manager's ownership share. Consequently, if firms owned by family that no separation between manager and owner means agency costs tends to eliminate.

Ownership Types

Type of ownerships divided into family ownership, corporate ownership and corporate blockholder. These kinds of types will influence SMEs' strategy choices and their performance related with the degree of acceptance to risks. The study of relationship between type of owner and strategic behavior has not been well researched despite its predictable implications; meanwhile type of ownership is influence in incentive system and control of a business.

Family ownership has several advantages (Poza, 2004, as cited in Fernandez & Nieto, 2006) including long term orientation, flexibility, speedy decision-making and family culture as a root of pride and commitment. And yet there are disadvantages especially getting external funding access and resources needed to support their sustainability such as assets based intangible knowledge or technology, unwell known brand and limited capability of human resources. Besides that, conflict of interest between business and personal objectives becomes blurred in this type of ownership. Commonly, SMEs owned by family have inexpert human resources internationally. Financial decision depends on family objectives that dependent from outsider's control. These factors have an impact on international involvement and strategic behavior of SMEs. In short, it is difficult for family firms to a mass the resources needed to sustain a competitive advantage that can be exploited through internationalization. Based on this, family firm seems hesitate to expand internationally. Therefore:

Hypothesis: The international involvement of SMEs is negatively related to family ownership.

SMEs with a corporate ownership or even blockholder ownership would not be expected to face the difficulties outlined above. Both of them can finance the SMEs and provide collateral. Also, SMEs could get technology access, commercial and organizational knowledge (Allen & Phillips, 2000). Good structure, high product quality control and efficient choice in organization management are the condition that could make SMEs wider access in finance and market. As well as blockholder ownership that is a combination of ownership between family and corporation would get more advantages from corporations: first, corporate blockholder could help strategy adoption to get market access; second, corporate blockholder will favor the introduction of mechanisms aimed at resolving the conflicts of interest traditionally present in family firms.

However, we would not include the two of type of ownerships which are corporation and blockholder in this analysis because of based on preliminary research we found that there is no one SMEs has kind of these ownerships. Therefore, we just included one hypothesis above. Our hypothesis is summarized in Figure 1.

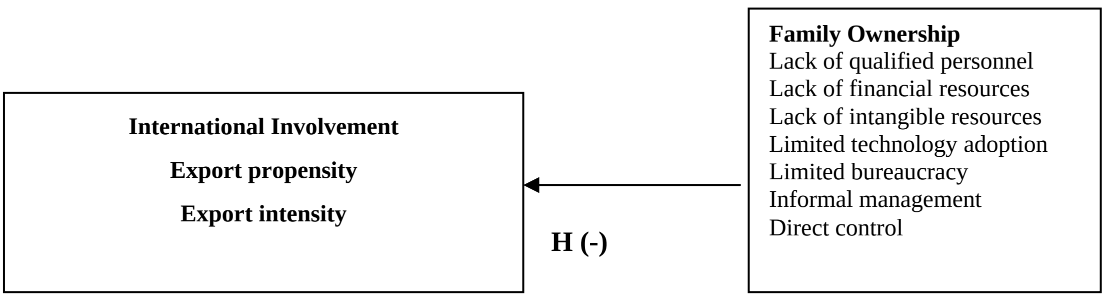

Figure 1. Family ownership, resources, and international involvement.

Empirical Analysis

Data Set and Variables

The source of the empirical data is data based onIndonesia Ministry of Cooperation and Micro, Small, and Medium Enterprises in 2010. The sample is representative of East Java SMEs. The observation includes 315 SMEs that spread in 36 cities that divided into three scale; micro, small and medium enterprises. This research would not choose the same SMEs with same industry in the same location with clear address for the purpose communication access (purposive sampling).

Total observation is 108 yearly firm SMEs since 2007-2009 represent the numbers of SMEs surrounding East Java. Distribution of location based on four influenceing cultures in East Java: (1) Arek is more open-minded (located in Surabaya, Sidoarjo, Gresik and Malang); (2) Mataraman is more patriarchy (located nearby Central Java- Blitar, Kediri, Madiun); (3) Pandalungan is more influence by religion leader and Madura (Jember, Probolinggo, Pasuruan, Madura); and (4) Osing (located in Banyuwangi). The distribution of location shows in Table 1.

Tabel 1

Location of SMEs in East Java

Location	Frequency	Percentage
Arek	40	37
Mataraman	15	13.9
Pandalungan	50	46.3
Osing	3	2.8
Total	108	100

Dependent Variables

There are three main internationalization strategies: exporting, licensing and direct foreign investment. As previous study by Fernandez and Nieto (2006), this research focuses on exporting activity, because this is the most common strategy adopted by SMEs to internationalize. This research used two dependent variables to asses the degree of international involvement: propensity to export and export intensity.

(1) Propensity to export (PEXP) indicates whether the firm is a non-exporter (i.e., export sales are equal to zero) or an exporter (i.e., all the cases);

(2) Export intensity (EXPINT) is measured by the ratio of export sales to total sales.

Independent Variables

To explore the impact of type of ownership, so we categorize the type of ownership in this research as follows in independent and control variables.

Independent: Family (FAM): a family SME; (0,1) dummy used in this model.

Control: These variables would explain clearly the relationship between family ownership and international involvement as Fernandez and Nieto (2006) done in their previous research located in Spain.

(1) Innovation (R&D): Total R&D expenditure/total sales. This variable use to control the potential behavior.

(2) Alliance (ALLIANC): SMEs firm have agreements with retailers and wholesalers; (0,1) dummy used in models. Alliances and cooperative agreements can improve the international performance of SMEs by providing resources and mitigating the uncertainty of the internationalization process.

(3) Age (AGE): Number of years since the starting year of SMEs's operation until the year of the observation. The firm's age variable is used to control its level of experience and accumulated resources, usually the result of a long process.

(4) Size (SIZE): Number of employees.

(5) Sector (SECTOR): Industry choices by SMEs.

Beside all above, to confirm SMEs' business scale, categorization of SMEs scale based on the Law No. 6-2008 about SMEs.

Micro scale: Minimum assets Rp. 50,000,000 with total sales yearly Rp. 300,000,000.

Small scale: Assets from more than Rp. 50,000,000 to Rp. 500,000,000 with total sales yearly from Rp. 300,000,000 to Rp. 2,500,000,000.

Medium scale: Assets from more than Rp. 500,000,000 to Rp. 10,000,000,000 with total sales yearly more than Rp. 2,500,000,000.

Table 2

Descriptive Statistics and Correlation Matrix of Independent Variables

	Mean	SD	1	3	4	5	6	7	8	9	10	11	12	13
1. EXINT	0.5676	0.3033	1											
2. FAM	1.00	0.000												
3. R & D	0.0105	0.0218	-0.388**	1										
4. Alliance	0.25	0.440	0.132	-0.221	1									
5. Age	14.73	7.349	0.075	-0.079	0.152	1								
6. Size	31.37	36.94	-0.131	-0.143	-0.067	0.345*	1							
7. D Sec 1	0.33	0.476	0.553**	-0.343*	-0.127	0.370**	-0.160	1						
8. D Sec 2	0.18	0.385	-0.185	-0.153	0.437**	0.081	0.388**	-0.327*	1					
9. D Sec 3	0.33	0.476	-0.446**	0.358**	-0.414**	-0.242	-0.146	-0.500**	-0.327**	1				
10. D Sec 6	0.08	0.272	-0.079	0.334*	-0.171	-0.139	-0.133	-0.206	-0.135	-0.206	1			
11. D As 1	0.63	0.488	-0.149	0.318*	-0.480**	-0.185	-0.095	-0.143	0.038	0.201	0.225	1		
12. D As 2	0.16	0.367	0.029	-0.134	0.490**	0.083	0.320*	-0.076	0.225	-0.305*	-0.126	-0.560**	1	
13. D Sal1	0.18	0.385	0.304*	0.184	0.083	-0.089	0.033	0.000	-0.214	0.000	-0.135	0.038	225	1

Note . ** Significant level 0.01 (one tailed); * Significant level 0.05 (one tailed).

Table 2 contains the descriptive analysis and correlations between variables.

Methodology and Results

Two empirical models of export behavior are estimated to test the hypothesis. Model 1 used a logit model to explain whether SMEs have made a decision to export or not and clarify the potential impact of variables on SMEs probability of exporting. Model 2 used linear regression to estimate determinant of export intensity based on family ownership. In both cases, methodology has been adjusted to process panel data as consideration on the existence of individual effects and provides consistency of the coefficient. Table 3 gives details of the models.

Model 1 is statistically significant below 0.5% level. It means the potential impact on the variables on SMEs probability of exporting is statistically supported. However, the model shows only one type of ownership in this research as an independent variable, FAM. Hypothesis—negative relationship between international involvements is not supported by this result. In other words, family ownership could not explain SMEs' decision-making in their strategic behavior to go internationally.

Among the control variables, ALLIANC and SALES have a negative role in modeling propensity to export. This is different with the estimation that those variables as positive predictors to enter foreign markets. Consistent with previous research, the higher SIZE variable increases the propensity to export. It is showing that the decision to enter global markets is positively associated with size of SMEs.

Model 2 reveals that family ownership is related to the second dimension of exporting behavior which is export intensity. Although family ownership was not a definitive factor in determining decision to enter foreign market, as well as export intensity, it is consistent with our hypothesis. Innovation (R&D) seems to be negative related to their international involvement. The other control variable, SALES is positively associated with export intensity.

Table 3
Empirical Models

	PEXP (1) Model 1	EXPINT (2) Model 2
FAMILY		
R & D	1,830.888	-4.263*
Alliance	-1.921*	0.179
Age	0.39	-0.006
Size	0.025*	0.001
Sector	-1.250	0.399 (1), 0.023 (2)
		0.048 (3), 0.274 (6)
Asset	0.249	-0.022 (small)
		-0.134 (medium)
Sales	-2.017*	0.316*
Const.	5.225*	0.447
R square	0.526	0.545
-2 log likelihood	95.230	
Chi-Square	0.000*	
Fit Model test	0.180*	*F*: 4.242*
Wald test	0.564	

Note. * Significant level 0.05 (one tailed).

Discussion and Conclusion

Different theoretical and methodology perspectives provide different results with previous study by Fernandez and Nieto (2006). Export behavior of SMEs in East Java which is owned by family could not explain their strategic behavior to enter foreign market. Moreover, business scales do not become constrain to get market access internationally. It supported by domination of micro and small scales in export. Even though there is a different perspective between SMEs to see their selves and government regulation (Law No. 6-2008 about SMEs). It shows in Tables 4 and 5.

This finding is consistent with previous studies of Bonaccorsi (1992), Knight (2001), Lu and Beamish (2001) who indicate business scale does not become constrain to compete globally. It is interesting to note that family ownership could not confirm the existence of relationship between type of ownership and export behavior in East Java. In this case, however, several control variables could be a predictor that potentially as a consideration to make strategic decision.

Table 4

SMEs's Scale Based on SMEs

Business scale	Frequency	Percentage
Micro	21	19.3
Small	69	63.9
Medium	18	16.7

Table 5

SMEs's Scale Based on Indonesia Government Regulation

Business scale (Law No. 6-2008)	Asset percentage	Sales (revenue) percentage
Micro	28.4	67.0
Small	51.4	30.3
Medium	19.3	1.8

The explanation from our findings is there are outsider agent beside SMEs taking a role as what we called "Competitiveness Agent" or in SMEs' term they called pooled agent. This role basically is known by SMEs to help SMEs in internationalization process. As a learning process, SMEs' consideration related to their characteristic and degree of risk aversion (Thomsen & Pedersen, 2000) and the SMEs' resource endowment (Shrader & Simon, 1997). As a result, alliances and agreements can improve the international performance of SMEs by providing resources and mitigating the uncertainty of internationalization process (Welch, 1992; Keeble, Lawson, Smith, Moore, & Wilkinson, 1998; Lu & Beamish, 2001). The alliances or agreement between supplier, wholesaler and retailer based cooperation alternative or trust (Snkovics, Cavusgil, & Roath, 2007) because indirectly can reduce transaction costs.

The risk avoidance of SMEs probably because of their fear of possibility loses of domestic/local market if they decide to enter foreign market as their main market. Transfer resource endowment to foreign market could be acted as a movement in unknown market. The limitation of information does not seem to be present in SMEs that have more employees. It means that human resources could be a consideration of SMEs because of their business does not based on capitals.

Moreover, the consideration in innovation as a factor to explain export performance must be supported by research and development expenditure. In this case, negative role of innovation could be explain that SMEs does not do their research and development by themselves because of lack of intangible resources adopted towards innovation and SMEs capacities (Allen & Phillips, 2000). "Competitiveness Agent" or pooled agent could be taking over this activity with only compensate as 1% from SMEs sales allocation. So, innovation should be a long term investment acted as transaction costs of "knowledge transfer" because of their limitation of technology adoption, lack of qualified personnel and lack of information access.

Despite this, the results on the relationship between family ownership and international expansion are not conclusive as it might be expected a consideration of theoretical and evidence. The limitation of this study should be a consideration for the next research. First, this research is a replication and research development from previous study in Spain, so the same methodology could be applicable but different characteristic of SMEs in Spain and in Indonesia. Second, family ownership would not be a fit variable to explain strategic behavior in internationalization. Third, there are others variables besides included in this research that give more contribution to make a internationalization decision. Lastly, this research did not include SMEs' life cycle as a consideration of international orientation choices.

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