Trust and Governance Mechanism in Indonesian Family Small Medium Sized Enterprises

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Abstracts

The purpose of this study is to examine the connection between trust and governance mechanism. The governance mechanisms in this study are formal and relational governance. Formal governance is associated with the application of a formal contract and administrative control. Relational governance believes that people behavior can be controlled by social elements that result from social interaction. The data collection was obtained through face to face interview with owner-managers of 350 family firms in Indonesia. This study used factor analysis to validate the construct and hierarchical regression to examine the hypothesis. The moderation testing indicates that trust has moderate relationship between uncertainty and formal governance. The result indicates that in the high trust situation, the impact of uncertainty on formal governance was negatively significant. It means that when people have high trust, firms who transact in uncertain environment have less required formal governance.

Keyword: Asset specificity, formal governance, relational governance, trust, uncertainty

1. Background

Family firms are acknowledged as important business entities that contribute to the world economy (Chu 2009). Faccio and Lang (2002), by using the data from 1996 to 1999, found that 44.29% of listed companies are family-owned business. Based on a survey conducted in 1995 in the United States (US), it was estimated that 60% of public businesses, private partnerships, and corporations were under family control (Astrachan & Shanker 2003). In Indonesia, more than 60% of publicly listed companies are owned by families (Claessens, Djankov, & Larry 2000). In Spain, based on data at the end of 2002, family business groups controlled more than 50% of listed firms (Sacristán-Navarro & Gómez-Ansón 2007).

This study investigated the role of governance in family SMEs in the context of a developing country by considering Indonesia as its main research site. Kowalewski et al. (2010) suggested that the majority of studies about family governance are conducted in developed countries, especially in Western countries. Kowalewski et al. (2010) argued that research in developed countries may not be fully applicable for developing countries due to the differences of legal systems and economic environments. Indonesia is an emerging country, in which family businesses and SMEs are dominant. More than 90% of business players in Indonesia are small to medium enterprises (Tambunan 2008), and most SMEs in Indonesia are private and family-owned business (Patrick 2001).

In the East Asia context, including Indonesia, using relational ties in developing business is part of business life (Carney & Gedajlovic 2001). Nevertheless, it is unclear whether relational governance is a preferred form of governance for the transaction of asset specificity and uncertainty for developing countries, including Indonesian family businesses (Goel, Jussila & Ikaheimonen 2014). Unfortunately, there is very limited information about family firm governance in the Indonesian context in the empirical research. This research, therefore, is dedicated to fill this gap in the literature.

Recent literature indicated that component of relational such as trust could be substituted or complemented toward formal governances (Mellewigt, Madhok & Weibel 2007; Poppo & Zenger 2002). Information about the substitute and complement of trust to formal governance may become an entry point to reveal when family SMEs should apply relational and formal governance. Costa and

Bijlsma-Frankema (2007 p.397) pointed out "low trust requires formal control and high trust allows for limited formal control." However, recent studies (Costa & Bijlsma-Frankema 2007; Poppo & Zenger 2002 & Mellewigt et al. 2007) discussed trust and formal governance in general context without distinguishing the size or types of business (family and non-family business). Furthermore, the literatures did not take into account the business dynamic of SMEs into the application of relational and formal governance mechanism. It led to speculate that not only trust needed to be investigated to reveal the appropriateness of the application of governance mechanism in family SMEs, but also organizational complexity as an impact of the dynamic of business.

2. Literature Review

Literature provides guidance for the application of formal and relational governance in family firms (e.g. Gedajlovic et al. 2004; James 1999; Mustakallio et al. 2002; Pollak 1985; Songini 2006; Verbeke & Kano 2010). The relational governance is developed through utilization of social capital that is embedded in personal relationship between firms' members (Mustakallio et al., 2002). Formal governance is built under formal contract between owners and managers (Gomez-Mejia et al., 2001).

The extension of TCT (Transaction Cost Theory) concerns about economizing bilateral transactions through formal contract and relational governance (Poppo & Zenger 2002). Formal contract relates to "a formal, legal, and economic governance strategy" (Vandaele et al. 2008 p.240). In this mechanism, each party specifies their right and obligation. Formal contract believes that legal sanction mechanisms are effective mechanism to mitigate opportunistic behavior (Ghosal & Moran 1996). Another mechanism is relational governance. Relational governance is governance mode that relies on social norms to secure economic exchange. This mechanism believe that the "level of understanding in a relationship will increase the overall commitment-level of the relationship" (Yu, Liao, & Lin 2006, p.130). TCT accommodates social norms as safeguard mechanism since many non-legal sanctions can encourage the fulfillment of commitment (Carson et. al. 2006; Macaulay 1963).

The most recent TCT literature discusses about the efficacy of formal and relational governance in mitigating exchange hazards such as asset specificity and uncertainty. The proponent formal contract suggested that the increasing asset specificity and uncertainty will lead to the adoption either formal contract (Ferguson, Paulin & Bergeron 2005; Lee & Cavusgil 2006; Vandaele et al. 2008; Rangarajran & Gemmel 2007; Zhou & Poppo 2010). This approach argues that a more complete contract is appropriate respond for the increasing of asset specificity and uncertainty. In contrast, relational governance view that cooperation and trust are the effective way to govern business exchange (Zaheer & Venkatraman 1995). Therefore, some mechanism that relies on trust and promoting cooperation such as joint planning, and operation, and information sharing is appropriate to respond the increasing exchange hazard.

Asset Specificity

There are two primary transaction characteristics facilitate opportunism; they are asset specificity and uncertainty (Williamson 1985). Asset specificity refers to the assets, which are dedicated for particular purposes and their value will decrease when utilized for other purposes (Williamson 1985). Uncertainty has been connected with unpredictable situation in the future (Noordewier, John & Nevin 1990). In transactions, asset specificity increases exchange risk due to relationship dependence and leads to higher switching cost (Madhok 1995). When parties invest on specific assets through inter-firm relationships, the values of assets depends on the participation of their business partners (Nooteboom 1993; Williamson 1981). When business partners terminates business relationships, the value of asset will decrease since there is no alternative use for these assets (Noorderhaven 1995). The absence of alternative purposes in transactions will lead to opportunism as the usage of assets requires participation from business partners (Nooteboom 1993).

Transaction asset specificity can lead to opportunism since it creates a situation in which one party can get an excessive portion of quasi rent through bargaining (Hill 1990; Williamson 1996). Quasi rent is "the excess above the returns necessary to maintain a resource in current operation" (Hill 1990 p.500). When parties are involved in transaction, the value of this asset is dependent upon the participation of the other party (Cannon, Achrol & Gundlach 2000).

Uncertainty

TCT views uncertainty as an important factor that explain in governance choice (Geysken et al. 2006; Rindfleisch & Heide 1997). Uncertainty is defined as "the difference between the amount of information required to perform the task and amount of information already possessed by the organization" (Gilbraith 1973, p. 5). Uncertainty arises if the situation surrounding an exchange is unpredictable. This means that contract cannot easily be specified and performance is difficult to verify (Geysken et al. 2006). Uncertainty also leads to renegotiation of contracts and the searching of new business partners that are associated to cost of transactions (Crook et al. 2013).

Uncertainty in this research encompasses three dimensions: volume uncertainty, technology uncertainty, and behavioral uncertainty (Crook et al. 2013). Volume uncertainty refers to the difficulty in predicting the availability of product required for transactors. Technological uncertainty refers to the extent to which current technology will become obsolete due to technologically advancement (Arranz & Arroyabe 2011). Behavioral uncertainty refers to the difficulty in evaluating performance of product delivered (Vandaele, D. et al. 2007).

The main consequence of uncertainty is adaptation problems (Gesyken et al. 2006). An existing contract may not cover unanticipated situations surrounding the exchange (Noorderweir et al.1997). High levels of uncertainty increases the costs of adapting the contractual agreement (Rindfleisch & Heide 1997). In uncertain situations, TCT suggests that hierarchical governance is more favorable over market governance (Williamson 1985). When uncertainty is high, economic actors find it difficult to manage transactions via market governance since contracts cannot be easily specified (Barney & Hesterly 2006). Hierarchical governance is more adaptive than market governance and thus potentially produces a low impact in the transaction cost elicited by the uncertainty (Poppo & Zenger 2002; Williamson 1985).

Uncertainty contributes to increased transaction risk since formal contracts might not be able to completely cover the situations surrounding a transaction (Zhou et al. 2008). The limitation of people to absorb process information and predicts information in bounded rationality, meaning that contracts are always incomplete in a nature, and therefore, lead to adaptability problems related to environmental uncertainty (Carson et al. 2006).

Asset Specificity and Governance Mechanism

Asset specificity refers to the asset that is only valuable for a particular transaction where its value will decrease when it is redeployed to conduct other transactions (Poppo & Zenger 2002; Zaher & Venkatraman 1995a; Zhou et al. 2008). In inter-firm relationships, asset specificity has been confirmed to influence the application of formal and relational governance (Jap & Ganesan 2000; Poppo & Zenger 2002; Vandaele, Rangarajan, Gemmel & Lievens 2007). Family business is frequently connected to a unique development of human assets (Dyer 2006; Sirmon & Hitt 2003; Verbeke & Kano 2010). However, it is inconclusive whether asset specificity also affects the governance mechanism in family firms (Verbeke & Kano 2012).

Uncertainty and Governance Mechanism

Others scholars linked the adoption of formal and relational governance to external factors, in particular, uncertainty (Peng & Jiang 2010; Peng & Luo 2000; Zhou, Poppo & Yang 2008; Zhou, Li, Zhao & Cai 2003). Zhou et al. (2003) argued that lack of legal enforcement in emerging countries led to uncertainty in business relationships, making relational governance more favorable than formal governance. Similarly, Zhou et al. (2008) suggested that in China, relational governance is favorable to attenuate opportunism in business relationships. They developed Peng's (2003) ideas that suggested that strategic choice acknowledged a transitional institutional process. In the first phase, managers relied on personalized relationships in governing transactions. In the second phase, transactions were more impersonal and managers relied on rules. However, the China studies were not conclusive on the connection between the institutional phase and the adoption of governance mechanisms.

Trust in Inter-firm Relationships

In one definition, trust refers to "the expectation that another organization can be relied on to fulfill its obligations, to behave in a predictable manner and to act and negotiate fairly evenly when the possibility of opportunism is present" (Gulati, Ranjay & Nickerson 2008, p. 167). Trust in business generally refers to the "expression of confidence between the parties in an exchange" (Jones & George 1998, p. 531). Mayer, Davis & Schoorman (1995 p.172) proposed the definition of trust as "individual willingness to be vulnerable to the actions of another party based on the expectation that the other will perform a particular action important to the trustee, irrespective of the ability to monitor or to control that other party." People trust others because they expect that others will behave in a particular way (Mayer et al. 1995) that produces favorable outcome (Cristina Costa & Bijlsma-Frankema 2007).

Trust in family firms is the result of the extension of social interactions within the families (Steier & Muenthel 2014). Social interaction in families inherently cultivates trusting relationship since they have special relationships based on blood and love (Kepner 1983), similarity of "family identity" (Zelwegger et al. 2011), and "language" (Davis, Allen & Hayes 2010). Building trust is part of affectionate process that begins in infancy as parents (or other primary caregivers) care for and provide the needs of young children for food, warmth, comfort, love, security, and human response (Bubolz 2001). In family firms, trust is an essential basis for cooperation and provides firms competitiveness (Steier 2001). Trust is important in family firms since it stimulates cooperation within and between firms. As Steier and Muenthel 2014 (p.498) noted "familial trust provides an essential lubricant that facilitates exchange relationship." Trust can be transferred from family affiliations to the work environment, and through the development of personal relationships into business exchanges (Salvato & Melin 2008).

The relationship between firm and their stakeholders often rely on trust rather than formal contract (Gedjalovic & Carney 2010; Memili et al. 2011a; Verbeke & Kano 2010). Connections between family firms and their suppliers and customers are often stronger and more valuable than those of non-family firms (Lyman 1991). A good relationship with other stakeholder can produce bridging social capital (Gedjalovic and Carney 2010). Family firm can built relationships with other parties whom they did not know previously, through current connections. A good connection between family firms and stakeholders is often connected with stakeholder efficiencies (Aronoff & Ward 1995).

Trust has been acknowledged as an essential element in cooperation between individuals, groups, and organizations (Gambetta 1988; Jones & George 1998; Zaheer, McEvily & Peronne 1998; Fulmer & Gelfand 2012). The success of any form of collaboration needs a minimum level of trust (Costa & Bijlsma-Frankema 2007). When people work together, the outcome cooperation does not only depend on one party's performance but also others parties' performance (Mayer, Davis & Schoorman 1995). Therefore, they need to trust one another. However, people cannot ensure that business partners will always behave in ways according to their organizational goals; therefore, trust is risky (Das 1998). Even though trust is associated with risk taking behavior, people may decide to collaborate because they have confidence in the future prospect of collaboration (Das & Teng 1998).

In economic exchange, when people trust one another, they do not need formal control to ensure that the other party will not engage misconduct behavior (Mellewigt, Madhok & Weibel 2007a; Puranam, P. & Vanneste, B. S. 2009). In relationship exchange, trust minimizes coordination complexity and conflicts due to the future uncertainty and bounded rationality that inevitable exist (Gulati et al.2005; Puranam & Vanneste 2009). High levels of trust do not only decrease the need to monitor performance, but also eliminate the need to use a system control based on a short term performance orientation that does not support innovation and cooperation (Hosmer 1995).

Family firms have been associated with high level of trust within the organization (Corbetta & Salvato 2004; Eddleston et al. 2010). Special relationships based on blood and love (Kepner 1983), similarity of "family identity" (Zellweger et al. 2011), and "language" (Davis, Allen & Hayes 2010) encourage trusting relationships in family firms. The long term relationship among family members also creates trust in family firms (Eddleston et al.2010). The internal relationships within families, characterized by "face to face interaction, positive affection, mutual support and altruistic feeling among family members" (Zellwegger et al. 2011 p.5), potentially facilitates trusting relationships in family firms.

Literature suggested that in a situation where people have low trust towards formal institutions, as in Indonesia, personal relationships are more likely to be used to reduce uncertainty (Rademakers 1998). In addition, by relying on relational ties with Indonesian state officers, for instance, people can get facilities that can only be accessed by limited persons (Rademakers 1998). This is because state officers have the authority to manage rules of the game that favor their business partners (Rademakers 1998). Rademaker (1998) also found that in Javanese business, authority is located and centralized into a person. Due to strong personal influence, informality is more salient than formality in business relationships. Because of this tendency, personal relationship is more relevant rather than contract, formal procedures, and formal rules.

Some scholars indicated that level of trust (Mellewigt, Madhok & Weibel 2007b; Poppo & Zenger 2002) could be used to signal the application of the governance mechanism. In economic exchange, when people trust one another, they are less likely to use formal controls to assure that the other party will not engage in misconduct behavior (Mellewigt, Madhok & Weibel 2007b; Puranam, P. & Vanneste, B.S. 2009). High levels of trust have been connected with the low intention to use formal governance mechanisms (Mellewigt, Madhok & Weibel 2007b; Poppo & Zenger 2002).

Adam & Tisdell (2008) conducted research about inter-firm cooperation among small-medium enterprises (SMES) in the garment industry in Bandung, Indonesia. They found that trust and competency are essential factors that promote cooperation in inter-firm relationships. Trustworthy and competent partners encourage firms to maintain long-term relationships. They found that inter-firm relationships increased capabilities in marketing and production and reduced transaction costs. They reported that continuity of business cooperation is found among firms that initially use repeated business contacts and family connections.

Hypothesis 1

The relationship between asset specificity and formal governance is weaker when high trust exists.

Hypothesis 2

The relationship between uncertainty and formal governance is weaker when high trust exists.

3. Research Method

Data collection was conducted from November 2013 until January 2014 through questionnaires which were hand-delivered to family business owners or managers of family SMEs. The research assistants visited the respondents and helped them to fill out the structured questionnaires since not all family business owners have good literacy and understanding about business terminology. Before the respondents filled out the questionnaires, consent forms were given to the respondents. The process of filling out the questionnaires took between 50-70 minutes on average. Data collected by the research assistants were cross-checked by the researchers to ensure the completion of the questionnaires. In the case where questionnaires were not completed, the research assistants contacted the respondents through telephone calls and asked the respondents to address the missing answers.

This study was conducted under a quantitative research approach, in which the data were coded, calculated, and quantified in order to understand the concepts represented (Creswell 2009). Quantitative research emphasized the examination of relationships between variables that function to test the objective of theories (Creswell 2002). To test the hypothesis, this study used hierarchical regression.

This study adopted a positivist view as the research paradigm. The positive paradigm views that reality exists and follows a natural law (Neuman 2014). In administering the survey, the researchers asked the same questions to many respondents (Neuman 1997, p.250). From the data collected from the survey samples, the researchers were able to make generalizations about the characteristics of the population (Creswell 2009). Survey was considered as an efficient method because it reached a high number of respondents in a limited time (Neuman 2014).

The definition of trust in this research refers to definitions delivered by Mayer, Davis, & Schoorman (1995) and Zaheer dan Venkatraman (1995). Meyer et al. (1995) defined trust as “an individual willingness to be vulnerable to another party and the expectation that an exchange partner will not behave opportunistically even when such behavior cannot be detected” (p. 712), in contrast to Zaheer and Venkatraman who focused solely on the inter-organizational relationship dimension of trust, this research also looked within firms. This research used the instrument of trust from (Zaheer & Venkatraman 1995). The score of Cronbach Alpha in this construct was 0.751.

Table 1. Questions about Trust

No	Questions	Loading Factors	Cronbach	Likert Scale
	Trust			
1	Our enterprise and supplier(s) share mutual trust	0.734		1=Do not agree at all 5=Totally agree
2	In decision making, our enterprise and supplier(s) are concerned about each other’s interests	0.583		
3	Our enterprise and our selected buyers have mutual trust	0.744		
4	In decision making, our enterprise and selected buyer(s) are concerned about each other’s interests	0.729		
5	The people in our enterprise are honest and truthful	0.34	0.751	

Testing for Moderation effect of Trust

This study predicted that the effect of asset specificity, uncertainty, and formal governance was moderated by level of trust. The different situations of trust would have some consequences on the relationship between asset specificity, uncertainty, and governance mechanism. When the level of trust was low, the relationship between asset specificity, uncertainty, and governance mechanism was strong. Conversely, when the level of trust was high, the relationship between asset specificity and uncertainty on formal governance was weak.

To test a moderating variable, this study followed procedural testing suggested by Lee & Cavusgil (2006) that was adopted from Sharma et al (1981). According to Lee & Cavusgil (2006), to test moderating variables, data were separated into two groups based on the level of attribute of moderator variable (low-high) and then were regressed. Next, a Chow Test was employed to test the differences of regression analysis between two groups. If the differences between the two regression analyses were significant, we could conclude that the factor that made the difference is the moderating variable.

Table 2 Testing for Moderation effect of Trust

	Model 1		**Model 2**	
	Formal governance		Relational governance	
	High (trust)	Low (trust)	high (trust)	Low (trust)
Independent variables				
Asset specificity	.492***	.402***	.295***	.400***
Uncertainty	-.527**	-.033	-.372***	-.192
Control variables				
Industry Size	.100	.341	.194	.160
Firm’s Ages	.176	.077	.059	-.037

Firm's Types	.145	-.015	-.241	-.211
Firm's Leadership	-.040	-.278	-.086	-.067
Chow Test(F8, 315)				

*** p <0.01
** p <0.5
* p <0.1

The Result

The result showed the differences on the influence of uncertainty on formal governance in high and low trust situation. When trust was high, uncertainty had negative and significant impact on formal governance (p<0.5, t=-2.372). In contrast, when trust was low, uncertainty had no significant impact on formal governance (p>0.5, t=-0.150). Based on this result, trust had moderate relationship between uncertainty and formal governance. Whilst, the result demonstrated that there was no different influence of asset specificity on formal governance in high and low trust situation. Asset specificity had significant impact on both high and low trust situation, and similar result was found on relational governance. When the level of trust was high, uncertainty has negatively significant impact on relational governance (p< 0.01, t=-2.93). But, when the level of trust was low, uncertainty did not have significant impact to relational governance (p>0.5 t=-.613).

The result of Chow-Test indicated that two groups of regression analysis were significantly different. In the first group of regression testing, F test (163.18) was bigger than F table (8.53). Similarly, in the second group of regression, F test (238.65) was greater than F table (8.53). The moderation testing indicated that trust had moderate relationship between uncertainty and formal governance. In high trust situation, the impact of uncertainty on formal governance was negatively significant. It meant that when people have high trust, firms who transacted in uncertain environment had less required formal governance.

4. Discussion and Conclusion

In the test of moderation, the result showed that trust had moderate relationship between uncertainty in both formal and relational governance. In the high level of trust situation, the effect of uncertainty on formal governance was negatively significant. In contrast, when the level of trust was low, uncertainty did not have significant impact on formal governance. The same result was also found in relational governance. When the level trust was high, uncertainty had negative significant impact on relational governance. Reversely, when the level of trust was low, the uncertainty did not affect relational governance. This result suggested that trust had moderate relationship between uncertainty and formal governance. In contrast, the result was inconsistent with the literature since trust did not only have moderate relationship between uncertainty and formal governance but also on relational governance. In the literature, trust only moderately affected the relationship between uncertainty and formal governance.

The moderation testing indicated that trust had moderate relationship between uncertainty and formal governance. The result indicated that in the high trust situation, the impact of uncertainty on formal governance was negatively significant. It meant that when people have high trust, firms who transacted in uncertain environment had less required formal governance.

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