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Director Pay in Family Firms from the Agency Theory Perspective

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ABSTRACT

Agency theory explains that managers have their own interests and are less focused on the firm's objective, which is the priority among shareholders. Agency theorists argue that to align similar interests between managers and shareholders, one must provide remuneration. Remuneration awarded to the board of directors leads to motivation to work harder to achieve the firm's objective. The board of directors' activities should be monitored in order to ensure they match the firm's objectives. However, it is hard to keep monitoring the board of directors, which leads to agency cost. A remuneration committee needs to ensure the remuneration process follows the policy and procedure. As a result, it may mitigate the agency problem and agency cost. The role played by the remuneration committee is less effective when applied in a family firm due to power and control being held in the family executive's hand.

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INTRODUCTION

Agency theorists make the assumption boards of directors have their own interests, which might conflict with the objectives of increasing shareholder wealth and may impact firm performance. This conflict of interest is known as the agency problem, which is defined as the presence of dissimilar goals between principal and agent (Jensen and Meckling, 1976, Fama and Jensen, 1983). In family firms, the agency problem occurs between majority and minority shareholders (Young *et al*., 2008, Peng and Jiang, 2010).

The conflict is exacerbated due to minority shareholders having little opportunity to monitor the activities of majority shareholders or to check their power within firms. Eisenhardt (1989) describes the difficulty and costs associated with internal monitoring by the principal as contributing to agency cost, which is the cost incurred as a result of the agency problem. Therefore, agency cost gives shareholders incentives to invest in monitoring and incentives to boards of directors to raise performance as protection against potential losses.

Agency theory is limited in explaining the conflict of interest between majority and minority shareholders in family firms. In family firms, there is no separation between ownership and management or control (Anderson and Reeb, 2003, Gomez-Mejia *et al*., 2003, Claessens *et al*., 2000, La Porta *et al*., 1999), which contrasts with practices in non-family firms. Regardless, there is potential to increase conflict between majority and minority shareholders in family firms (Peng and Jiang, 2010, Young *et al*., 2008). For example, the uniqueness of family firms is closely related to the fact that key positions within the firms are held by family members, who can even hold more than one important position simultaneously, which provides spaces for expropriation.

Discussion:

Many agency theorists' perspectives explain that to mitigate the agency problem and agency cost, firms should offer attractive incentives and implement effective monitoring. According to Fama and Jensen (1983), the combination of incentives and monitoring can mitigate the agency problem and agency cost. Through this combination, performance may be improved, which tends to attract more move investment. Diagram 1 shows a conflict between majority and minority shareholders and the solution of the conflict under agency theory.

The diagram above shows that agency theory will create a conflict in a firm. Agency theory is divided into two parts, the agency problem and agency cost. The conflicts may affect a business's performance and stakeholder interests, such as those of creditors, banks, government and shareholders. Due to this, it is very important that these conflicts

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are curbed curve at an early stage before they become serious to ensure that the business's operations and objectives are not interfered with by interested parties. For further action, the firm should come with better incentives and effective monitoring to mitigate the conflicts. The implications of this notion are that performance will improve, which will enable a successful future.

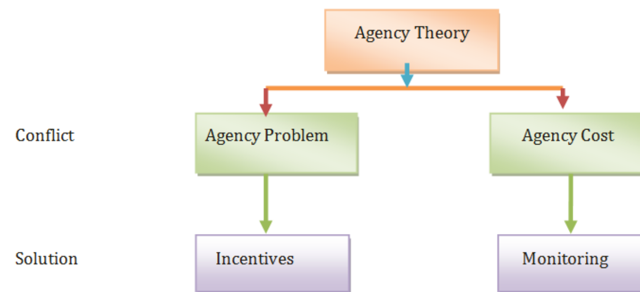

Diagram 1: Agency theory, conflict and solution.

Agency problem and agency cost:

Family executives who sit on boards of directors and remuneration committees, and also majority shareholders, believe that the firm itself is a place to store up wealth, which contributes to the agency problem. This is not what minority shareholders expect from family executives who run the business but rather that they carry their responsibility to achieve better performance. This is because the main reason the minority shareholders made investments was to gain better returns via dividend payouts in order to increase their wealth. Furthermore, the agency problem in family firms is between majority shareholders (i.e. family executives) and minority shareholders.

According to Peng and Jiang (2010) and Young *et al*. (2008), majority shareholders often refuse to maximize profits because they are unable to separate their own interests in increasing remuneration. Moores and Craig (2008) agree that majority shareholders possibly misuse their power and control to increase their personal wealth. Thus, the participation of family members in management, including the remuneration process, can be questioned about transparent manner? Power and control being held by family executives may provide opportunities to manipulate the remuneration process by less strictly following the procedure. This shows that the remuneration does not link with family executives' abilities, such as skills and knowledge. The business may not achieve better performance due to family executives' having less capability to come up with good business strategies and planning.

Core *et al*. (1999) explain that an increased agency problem is a bad indicator for long-term firm survival and must be addressed early before the problem causes firms to lose large amounts of revenue over time. They found that the extent of the agency problem is positively related to poorer firm performance. Due to this, shareholders are not happy with the situation and may possibly withdraw their investments from the firm, affecting the firm's reputation.

The top position in a business is usually held by a family executive, such as chief executive officer (CEO), chairman or executive on the board of directors. This provides an opportunity for the family executive to manipulate the position for personal interests, which may harm minority shareholders due to worse performance, affecting the dividend payout. This shows that a serious agency problem tends to bring the business into trouble.

Diagram 2 shows the relationship between the agency problem and the family firm, and Diagram 3 shows the relationship between performance and the agency problem.

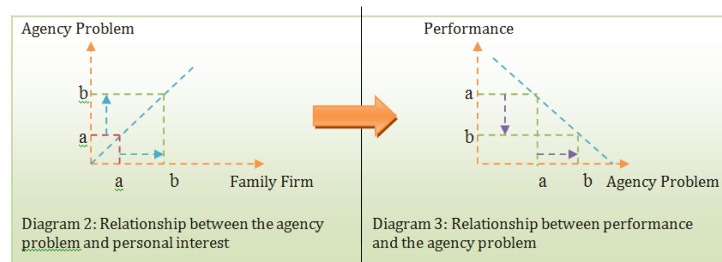

Diagram 2: Relationship between the agency problem and personal interest

Diagram 3: Relationship between performance and the agency problem

Besides a conflict of interest regarding objective achievement between majority shareholders (i.e., family executives) and minority shareholders, another issue that tends to contribute to conflict is monitoring aspects related to family executive activities. It may be possible to effectively monitor

the power and control held by family executives. Furthermore, minority shareholders often lack knowledge, skills and talent specific to the firm's operations, as compared with majority shareholders, which could also contribute to increases in agency cost (Tosi and Gomez-Mejia, 1989). This shortcoming is a disadvantage for minority shareholders because it limits them in gaining access to information related to executive remuneration.

Minority shareholders are not involved directly in firm operations, which may also limit their access to management information. Thus, minority shareholders' monitoring disability provides space for the board to increase personal benefit via excessive remuneration and possibly bring financial problems in the future. As a result, agency cost rises, which could lead to a loss in profits (Anderson and Reeb, 2003). This can significantly impact firm operations and prevent strategies and planning from being implemented, resulting in lowered dividend payouts.

Low dividends lead investors to sell their shares due to a loss in confidence in the ability of firms to raise profits. Furthermore, family firms can intentionally build up barriers via remuneration committees (i.e., family members who are members of committees) between the family group and minority shareholders in order to ensure limited opportunities to question remuneration and participate in the remuneration process. Thus, minority shareholders find it difficult to monitor firm activities and, instead, possibly increase agency cost.

Diagram 4 shows the relationship between monitoring and power and control, and Diagram 5 shows the relationship between agency cost and monitoring.

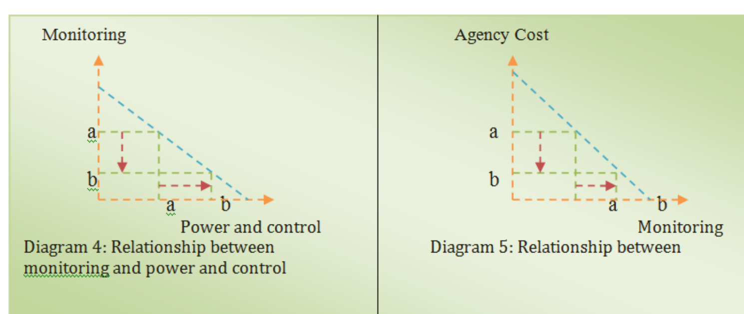

Diagram 4: Relationship between monitoring and power and control

Diagram 5: Relationship between

Family firms prefer to use power and control to hide their activities, especially related with personal matters, and this makes it hard for minority shareholders to conduct effective monitoring. The implication of this notion is that possibly the agency cost will increase, and there will be open space for family executives to increase their wealth through higher remuneration even though they are not qualified. Agency theory shows that the conflict between majority shareholders and minority shareholders occurs due to personal interest intentions by family executives who are also majority shareholders. Therefore, it is very important to bring similar interests to ensure the business's success in the long term. Agency theory suggests providing better remuneration and effective monitoring to mitigate the agency problem and agency cost.

Incentives and monitoring:

As previously discussed, the agency problem and agency cost may decrease firm performance, as consistent with the agency theory argument. However, other scholars argue that the agency problem and agency cost can be mitigated by using incentives and monitoring (Jensen and Murphy, 1990, Murphy, 1999, Andreas *et al*., 2010, Hartzell and Starks, 2003), which tend to align majority and minority shareholders' interests (Jiang and Peng, 2010, Young *et al*., 2008). In other words, shareholders can motivate managers by controlling their remuneration. Generous remuneration can drive the motivation of boards of directors to work harder to increase firm performance (Murphy, 1985, Kaplan, 1994, Letza *et al*., 2004). Additionally, agency cost could be mitigated with links to institutional investors. According to Abdul Wahab and Abdul Rahman (2009), monitoring by institutional investors enables firms to curb remuneration and increase firm performance. This situation is less effective in applying to family firms due to the unique firm characteristics.

However, in the family firm context, family executives who are members of boards of directors and majority shareholders obtain two benefits if they accept remuneration contracts: First, they receive better remuneration composed of a high salary, large bonuses or both as well as stock options (Basu *et al*., 2007, Croci *et al*., 2010, Bebchuk and Fried, 2003). Second, as shareholders, they can receive large dividends based on firm performance. The logic of these two incentives can be used to possibly influence majority shareholders to recalibrate their private intentions toward increased shareholder wealth (Hölmstrom, 1979, Andreas *et al*., 2010). Prior studies indicate that there is a positive relationship between CEO remuneration and firm performance (Murphy, 1985, Kaplan, 1994, Barkema and Gomez-Mejia, 1998), which is consistent with agency theory (Fama and Jensen, 1983).

As previously mentioned, mitigation of the agency problem and agency cost contributes to long-term success. This requires majority shareholders to dismiss personal interests for firm objectives. As a result, the agency problem in both firms with separate ownership and control (Jensen and Meckling, 1976) and family firms (Claessens *et al*., 2000, Anderson and Reeb, 2003) can be reduced via incentives and monitoring, as suggested by agency theory. This will moderate a better relationship between remuneration and performance.

Agency theorists (e.g., Jensen and Meckling, 1976, Fama and Jensen, 1983, Jensen and Murphy, 1990, Murphy, 1999) argue that the dissimilar interests between principal and agent (non-family firms) and principal and principal (family firms) lead to an increased agency problem. The agency problem is closely related to family ownership when family members are involved in remuneration setting. As a result, pay and performance are not linked, as required by firm policies and procedures.

Remuneration committees are easily influenced by family executives because they lack real independence and power, as they are appointed by boards of directors. The remuneration process leads to an opportunity among family members to increase personal benefits. For example, it is necessary for the remuneration committee to propose remuneration to boards of directors and majority shareholders for approval. Boards are willing to accept proposals for remuneration if the packages increase personal benefits; otherwise, they reject them.

Agency theory suggests that providing attractive incentives can help to mitigate the agency problem. Through incentives, family executives can be motivated to work to maximize firm profits (Bebchuk and Fried, 2003). As a result, this enables firms to attract minority shareholders to invest and allows firms to diversify. Pay-for-performance requires members of boards of directors to use their talents (i.e., skills, knowledge and experience) to increase firm performance. In other words, executives are more willing to fulfill firm objectives by using their talents if they are satisfied with the incentives. According to this notion, incentives mitigate the agency problem and increase firm performance and investment. However, this is not easily implemented in family firms due to expropriation issues.

Family executives tend to increase their voting rights through shareholding to provide opportunities for expropriation via excessive remuneration from minority shareholder wealth. In addition, minority shareholders have difficulty monitoring family executive activities because they are less involved in management. As a result, family member wealth consistently increases, while minority shareholder wealth decreases steadily. This phenomenon results in serious agency cost.

Agency theorists suggest that mitigating agency cost falls under the responsibility of institutional investors to monitor majority shareholders' behavior in order to link it with firm performance. Institutional investors play an effective monitoring role in curbing remuneration (Hartzell and Starks, 2003, Abdul Wahab and Abdul Rahman, 2009). In other words, institutional investors have the ability to prevent expropriation by family executives through monitoring because they are independent of board appointment and control. Institutional investors need to increase their voting rights to let them participate in the remuneration process. Subramanian and Wang (2009) explain that this provides opportunities to penetrate majority shareholder walls by participation in remuneration processes, including approval stages. Thus, effective monitoring can mitigate agency cost and increase firm performance and minority shareholder wealth.

Conclusion:

Boards of directors who are less focused on business and instead are focused on personal matters tend to increase the agency problem because their objective is dissimilar to the shareholders' objective to better firm performance. Agency theory is limited in explaining the conflict of interest between majority and minority shareholders in family firms, which are also known as principal and principal. There is no separation between ownership and management, or control may cause the conflict in family firms. Furthermore, when family executives misuse their power and control for their own personal interests, it possibly leads to a serious agency problem. This situation may not be good for shareholders because a large amount has already been invested into the firm. In order to align similar interests between the principal and principal in family firms, agency theory suggests that better remuneration should be awarded to the board of directors. This increases the board of directors' motivation to work harder and links it with better performance.

A remuneration committee is required to follow the procedure and policy during the remuneration process to ensure it links with performance. This situation is very tough for the remuneration committee to effectively monitor, especially in family firms, because power and control are in the hands of family executives. The agency problem becomes serious in family firms between the majority shareholders (family executives) and minority shareholders. The disability of the remuneration committee to continue effective monitoring during the remuneration process may cause shareholders to withdraw their investments from the firm. Besides that, external monitoring should be provided to monitor the remuneration in order to be more transparent, and this role should be played by an institutional investor.

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