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IMPACT OF FAMILY OWNERSHIP, LEVERAGE, FIRM SIZE AND AGE ON AGENCY COST OF FAMILY AND NON-FAMILY FIRMS IN PAKISTAN

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Abstract

This study investigates the agency costs associated with family firms and non-family firms listed on Pakistan Stock Exchange (PSX). 15 family business from 5 big business groups (Dawood group, Nishat group, Habib group, Kohinoor group, Atlas group) and 15 listed companies on Pakistan Stock Exchange (PSX) are taken to make a sample of 30 firms. The data for this research has been acquired from annual reports of these 30 firms for the period between 2008 and 2016. This study found that agency cost of family firms is low as compared to non-family firms. Family ownership is negatively related to agency cost of family firm. Firm size, Firm age and leverage are also having a significant effect on agency cost of family and non-family firms.

Key Words: Family firms, Leverage, Agency cost, Firm size, Firm age

I. Introduction

Among the corporate and business structures, one of the most antiquated one is of "Family Firms (FF) or Family businesses (FB) holding a critical position in current financial scene. In family businesses, family members that are mostly blood relations or spouse influence decision-making and they are having ownership in the company. Family firms are considered better because of their long-term focus on excellence and loyal affiliation for their employees. But family businesses have to deal with many administrative issues because of certain business and family matters that raise problems.

Family firm (FF) is business involving kinship relations or blood ties. From the perspective of agency theory, guanxi culture provides an insight and is quite useful in easing the conflict of interest within the firm and to overcome and diminish costs of agency. And among these perspectives family businesses are viewed as proficient sort of business (Daily & Dollinger, 1992; Fama & Jensen, 1983b).

In this aim, this research study is undertaken to explore the impact of family ownership, leverage, firm size and age on agency cost of family and non-family firms in Pakistan

II. Literature Review

According to the point of view of Schulze, Lubatkin, & Dino (2003) and Schulze, Lubatkin, Dino & Buchholtz (2001) that there can be high agency costs in family firms on account of contentions associated with private ownership, as well as those postured by uneven benevolence, so that in comparison with non-family firms (NFF), their performance is less. Because of such prominence, researcher and policy makers invariably pay great attention to examine the aspect of agency cost in Pakistani trading FF. Various studies worked on this perspective that Family business owners always have feeling of compassion and kindness for their members so they try to adjust them in higher senior executive position. In response, courtesy members develop psychological commitment towards that enterprise and they consider organizational benefit as a mutual obligation. When organizational benefit is considered as the top priority then chances of individual opportunism become low which leads to less agency costs in family firms Kim & Gao (2013). Moreover, with this benevolence come faithfulness, devoutness and obedience of subordinates for superiors. This leads to solution of agency cost problem (Bell, 2010). Adam Smith (1776) gave the concept of principal and agent theory from where work on ownership structure started. Researchers (Fama & Jensen, 1983a, 1985; Jensen & Meckling, 1976: Basheer et al., 2018: bin Hidthiir et al., 2019)MNput light on those benefits and issues that ownership structure brings on the functioning of FF. As FF are found worldwide so researchers are interested in finding how agency cost (AC) is affected by family ownership especially in FF. Faccio & Lang (2002) did a study on family firms and 46% of 5234 companies were family businesses it shows that how the importance of family business has increased many fold.

According to the point of view of Jensen & Meckling (1976), problem of principal-agent is reduced because of family management and it also makes parallel benefits and incentives of management with the prospects of shareholders. Along with this family managers are considered to be wise and prudent. They have specific know how regarding firms so they have more mature approach towards management of firm and have long term investment horizon as well. Therefore, in this way FF may perform well comparatively than NFF.
As in FF family members have a role in ownership so in a way transaction cost of labor is reduced said by Tarziján (1999). La Porta (2000) contented that rights of those shareholders that in minority are misused through different ways. For example high paid senior positions are provided to close relatives which are in fact not qualified for that post. Pertinent family ownership advantages has been quoted theoretically by several studies (Fahlenbrach, 2004; Morck, Shleifer & Vishny, 1988; Palia & Ravid, 2002) which state positive relationship of family ownership (FO) on firm's performance. However, potential costs associated with FO will counterbalance the advantages held by it. Burkart, Panunzi, & Shleifer (2003) pointed out that as compare to firms handled by professional managers, a family owned firm may relatively be less capable and efficient and may incur loss. Thus, if a firm is under control of expert managers having professional attitudes as compared by family owned it is likely to incur less loss and retain its profits. According to Smith & Amoako-Adu (1999), negative markets reactions have been reported in stances where family firms have appointed or hired family members for position of mangers whereas Naughton (2001) firm value and performance is increased by pure family ownerships. Firm's market value was calculated via Tobins's Q and ROA was used to calculate performance. The results showed that agency cost of family firms was reduced through family ownership.

Maury & Pajuste (2005) with 1672 NFF tries to analyze that did companies of West Europe to study performance comparison of NFF; results indicated that FF performed well in comparison to NFF. Firm value is calculated by using Tobin's Q proved that family control raised its value by 7% to NFF. When profitability calculated by ROA was examined, FF than

NFF showed 16% higher profitability. In exploring effects of FO on firm performance, Anderson & Reeb (2003) did study on large public firms of the U.S. stating that NFF performed than FF. Both Tobin's Q and ROA were used for measuring firm's performance. Resulted indicated that ROA of NFF was less profitable as compared to FF. Moreover, they pointed out when a member from family acts, as CEO (chief executive officer) returns are even higher. They clarify that the family member has good understanding regarding operations of business can work with more devotion. Results from Tobin's Q revealed that FF is better in performance. Numerically results proved that FF had 10.5% greater Tobin's Q. Their results proved that family ownership (FO) signifies efficient organizational structure. DeVries et al. (1993) explains that early training of family brings several benefits related to the family factor such as a long-term investment horizon, freedom and culture of organization, and the expertise for the business.

According to the study of File & Prince (1998), FF loses strength because of two reasons. It can be a family related problem or a business related problem. Consecutive family succession of current management is a family related problem. Poor financial management is a business-related problem. So this fact is irrefutable that family component and business concerns both play their role in effecting performance of a FF whatever is the role of members of family in the business.

Therefore, it can be assumed that individual managers, can get hold because of seniority position in the family and in the business (Briely & Godfrey, 1999). If one has the power to have authority on senior members of family or he is having family related power and seniority. Position of a person in the hierarchy of organization and skill or expertise that a person processes, defines his business related power. Participation of children, succession of current family management, family earnings, and are mostly the issues regarding family firms. Studies disclose that concentrated ownership has some benefits as well as disadvantages on firm performance.

La porta (2006) argues that following are the reasons of negative impacts. It is obvious from various studies that in FF shareholders performs actions that enhances their benefits at the cost of poor performance of the firm i.e. to take own benefits while manipulating others. Families are capable to extract wealth and share in disproportionate form such as dividends and compensation. Shleifer & Vishny (1997) put their point of view that the agency cost doesn't arise only due to mangers and agent's conflict and it's not the agents acting as the only reason of agency cost, conflict between shareholders in minority and large shareholders having extensive control also cause agency problem. They redistribute wealth to themselves by extracting distinctive dividends. Faccio & Lang (2009) put forth their point of view that sometimes family firms hire less capable person on managerial positions just to give them a favor. In addition, they prefer them on external qualified candidates .Secondly in order to gain personal benefit families took incentives on profits instead of maximizing firm's value.

Pertinent to this, Lee (2006) also disclosed in case of FF at administrative level family members hold top positions instead of recruiting proficient non family members having expertise and skill. McConnell & Mikkelson (1984) put their point of view that having control in firm by family members enhances their ability to extract incentives and benefits on the cost of other shareholders. Previous studies points out both type of results i.e. positive and negative regarding FO impact and performance of firm. Wiwattan (2001) studied stated out positive results between family ownership and firm's performance about the non-financial firms listed on Thailand's stock exchange. Anderson & Reeb (2003) and Barontini & Caprio

(2006) work on family owned firms of S&P 500 indicates that FO does not affect Shareholders in a negative way. In similar way, studies Favero, Giglio, Honorati, & Panunzi (2006) and Sraer & Thesmar (2007) carried out in France and Italy reported that performance of family firms is better than non-family firms. Studies also that negative relationship exists between family firms and performance of the firms. For example, Perez-Gonzalez (1999) did a study on US firms and pointed out a negative relationship between FO and performance of the firm.

Faccio & Lang (2002) and Sraer & Thesmar (2007) report negative relationship FO and performance whereas Villalonga & Amit (2006) reports positive conditional relation exists between FO and performance if founder of company is its Chief Executive Officer (CEO) then family control will be favorable. In scenario of Pakistan, FO and its effect on performance is changed, where term "family group" is used to define FF. For example, the term "Family Business Groups" for family firms is used by Ashraf & Ghani (2005) and Ikram & Naqvi (2005). Large family firms as compare to small ones are said to be more profitable are more profitable suggested by Naqvi & Ikram (2004). Ghani & Ashraf (2005) have brought results that in terms with return on assets both positive and negative ROA shows a positive whereas Tobin's q is holds a negative relationship with FO.

Firm size and agency costs are also having a relationship. There are two contradictory views regarding it. As larger firms have abundant resources and they have efficient systems so it is helpful in reducing their agency cost suggested by Danes (2009). However another point of view put forth by Chu (2009) that in small family firms there lies an intimate relationship among family members so the problem of interest conflict is minimized and agency cost also diminishes in this way.

These finding contribute to current literature of agency cost in various ways. First, this sample is unique in its nature as it fill out the practical gap for not only evolving market instead it enhances comprehension of this segment .i.e. Family firms in Pakistan. Secondly, this study takes into consideration two distinguished elements of family firms: ownership and management where the former is about how family holds rights of cash flow and later is about how many family members can get a proportion on board of directors. Thirdly, Academicians will benefit from the findings of this research, as it will enhance existing understanding and knowledge in finance. The answer will establish how family ownership, leverage, firm size, firm age relate with agency cost of family firms in Pakistan. In addition, whether firm size, age and leverage is having any significant impact on family firms and nonfamily firms of Pakistan or not. Fourthly, after this study we will be able to investigate the influence of reciprocal benevolence among persons in family firms. Finally, for agency cost prerequisite consumption is being used as a proxy considering availability of data in annual report of both firms (family and non-family) registered at stock exchange of Pakistan. These finding add to current literature about agency problems of family owned firms by providing useful practices and implications.

Further layout of paper is organized in a way it sheds light on theoretical discussion, which leads to hypothesis development followed by research methodology. Afterwards empirical analysis and research implications are discussed and finally paper is concluded with limitations and future recommendations.

III. Theoretical Framework, Hypothesis Development and Research Objectives

There are two main reasons of agency cost i.e. Interest conflict and information asymmetry According to Jensen & Meckling (1976), Agency theory advocates the perspective that family firms are believed to be more productive and less costly one because of several reasons. To start with, possession basically held among blood relatives, so family agents work in the best interest of enterprise because of private property in this way agency cost caused by the interest conflict is also reduced (Fama & Jensen, 1983a). Secondly, shared correspondence and synchronization of tasks is more advantageous as it lessen the agency costs evoked because of asymmetric interaction (Daily & Dollinger, 1992; Fama & Jensen, 1983a:Basheer et al., 2018: Basheer, 2014).

Accordingly, first hypothesis is proposed.

H_1:.Family Firms have less agency cost as compared to nonfamily firms in Pakistan.
When the controlling family holds the larger share, in the company, it ensures the uniformity of interest with in the firm and it reduces interest conflict. In comparison with managers of non-family firms, managers of family firms always postpone their personal interest for the interest of firm so this leads to little or no agency cost (Chrisman, 2007; Karra.2006). Here second hypothesis is proposed.

H_2: Family ownership is negatively related with the agency cost of family firms
In case of firm size and agency cost, two inverse perspectives have been identified. Danes, Stafford & Loy (2007) contend that sounder frameworks and rich assets, decreases agency costs in case of large firms. Nonetheless, Chu (2009) observes that in smaller privately owned companies family members have close relationship, which can mitigate the conflict of interest in an organization and diminish the agency costs. Karra (2006) points out the effect of nuclear family structure prevalent these days that it makes conflicts of interest among family members more serious. So third hypothesis is proposed here.

H_3: Firm size is having a significant effect on agency cost of family firms and non-family firms of Pakistan. Debt contracts are a cause of increasing firm bankruptcy and lead to manager's unemployment. Debt contracts reduce free cash flow as well. It creates opportunistic behavior of agents and thus decreases agency cost (Jensen, 1986). So fourth hypothesis is proposed here.

H_4: Firm leverage is having a significant effect on agency cost of family firms as well as non-family firms of Pakistan. Chu (2009) describes an inverse relationship between firm size and agency cost. As with the age of firm governance, mechanism also strengthens which mitigates agency cost .So larger the firm age means sounder the governance mechanism and thus lower agency costs. So fifth hypothesis is proposed here.

H_5: Firm age is having a significant effect on agency cost of family firms as well as non-family firms of Pakistan.

Thus, Objectives of the study are to find:

1. How family firm's agency cost is less than non-family firms?
2. How family firm's agency cost is influenced by family ownership?
3. How family firm's agency cost is influenced by firm's age, firm size and leverage?

VI. Research Methodology

(i) Sample and Data

For this study, the period 2008 to 2016 is set. The study population was drawn from all the 30 firms both Family firms as well as Non-family firms that are listed on stock exchange of Pakistan. Data is available on in the annual reports of these companies. For family firms listed companies from these five big business group are being taked as sample: Dawood group, Nishat group, Habib group, Kohinoor group, Atlas group. For non-family firms 15 listed companies are taken into considerations that are registered on Pakistan Stock Exchange (PSX). Non-listed companies in Pakistan are excluded from the analysis.

We can identify the family firm using following criteria: firstly, individual or family should be the main shareholder of the firm and secondly, it is major shareholder.

(ii) Dependent Variable

Prerequisite consumption is being used as the proxy for agency cost. Since senior executives are mostly paid in cash for their prerequisite consumption. These details of cash paid related to operating activities are disclosed by firms in annual reports in notes to financial statements section in form of administrative expenses, conference expenses, overseas training fees, expense of board of directors, communication and entertainment.

(iii) Independent Variables

To denote family firm's dummy variable FF is used. If there is a family firm FF equals to 1 and FF equals to 0 if it is a non-family firm. Family ownership is used in terms of percentage shares held by members of the family.

Family management denotes number of family members included in board directors in proportion to total board of directors. Firm size is being calculated by taking natural logarithm of total assets. In case of free cash flow, in those firms that are having ample free cash flow and low growth, officials tend to make more investment to consume money than actually required which leads to increase in agency costs (Jensen 1986). We calculated free cash flow in our study as capital expenditure – operating cash flow. To calculate leverage, proxy of ratio of debt and assets was uses.

(iv) Model Specifications

In order to draw a comparison of both family and non-family firms with agency cost, following models of multiple regressions are used:

i. Model-- 1 only includes proxy of Family firms and a control variable to analyze and test H_I and H_3, H_4, H_5.

$$AC=B_{0+}B_1ff+B_2Size+B_3Age+B_4Fcf+B_5Lev$$

ii. Model (2) includes family ownership and (FO) and family management (FM) to test H_2.

$$AC= B_{0+}B_1FO+B_2\ FM+B_3Size+B_4Age+B_5Fcf+B_6Lev.$$

V. Results and Discussion

Table 1 shows correlation analysis of data of non-family firms (NFF). Results indicate that for non-family firms (NFF) firm's age and agency cost (AC) are positively related to each other. Whereas Size free cash flow (FCF) and leverage are negatively correlated with AC. Table 2 shows summarized correlation analysis of FF where age and AC are positively

correlated whereas Size of firm and AC are negatively correlated to each other. Leverage is also negatively related to AC of family firms. FCF and family ownership (FO) are also negatively related to AC. Family management (FM) and AC are positively correlated to each other. Results are summarized below in Table 2.

VARABLE	AC	AGE	SZ	LEV	FCF
AC	1				
AGE	0.1506	1			
SZ	-0.3108	0.1787	1		
LEV	-0.0002	0.3403	0.3812	1	
FCF	-0.046	0.1762	-0.2489	0.182	1

Table 1: Correlation (Non- Family Firms)

Variables	AC	AGE	SZ	LEV	FCF	FO	FM
AC	1						
AGE	0.1756	1					
SZ	-0.2434	-0.0859	1				
LEV	-0.0444	0.0874	0.4559	1			
FCF	-0.1294	-0.2285	-0.0935	0.2924	1		
FO	-0.0258	0.2328	0.1329	0.1806	0.1438	1	
FM	0.2062	-0.043	-0.2781	-0.1726	-0.152	-0.2818	1

Table 2: Correlation (Family Firms)

	Overall			Non-Family			Family		
	Coef.	Z	P>z	Coef.	Z	P>z	Coef.	Z	P>z
AC_{t-1}	0.540	602.650	0.000	0.412	97.90	0.000	0.618	27.070	0.000
AGE	-0.003	-5.960	0.000	0.023	5.630	0.000	-0.033	-3.140	0.002
SZ	-0.006	-23.780	0.000	-0.005	-18.84	0.000	-0.008	-2.920	0.003
LEV	0.004	5.260	0.000	0.010	2.820	0.005	-0.067	-4.770	0.000
FO							0.000	2.850	0.004

FM							0.041	4.090	0.000
_cons	0.129	54.400	0.000	0.022	1.140	0.255	0.274	8.880	0.000

Table 3: Generalized Moment of Method Test

Table 3 shows over all analysis of both firms family and non-family along with individual analysis. We applied generalized method of moments test which is used when we have few time periods and independent variables are exogenous.(means they are correlated with past).

In order to check multicolinearity stata uses sargan test. For that, it uses its own instruments. Our null hypothesis will be Ho= Instruments used are valid.

	Z	**Prob > z**	**Z**	**Prob > z**	**Z**	**Prob > z**
AR1	-2.2045	0.0275	-1.7953	0.0726	-1.2386	0.2155
AR2	-.2153	0.8295	.82982	0.4066	-.99881	0.3179
Sargan	25.30351	0.5019	10.52462	0.9969	12.16745	0.9902
Wald-Chi^2	485597.15	0.0000	13763.27	0.0000	3685.80	0.0000
No. of firms	30		15		15	
No. of Obs.	210		105		105	

Table 4: Sargan test and ArellanoBond test

No value is less than 0.05 0r 0.1 so we will accept that instruments are valid and there is no multicolinearity aspect. Arellano bond test is used to check auto correlation. We have autocorrelation upon some extent in first order while doing overall analysis FF and NFF. However, issues of autocorrelation were resolved when Arellano bond test was applied in second order. While checking auto correlation for family and nonfamily firms' data we can see there is no auto correlation. All probabilities are greater than 0.05.Wald chi square is used to check overall fitness of model probabilities are 0.0000 so it means that our model is overall fit (Basheer et al., 2019).

VI. Conclusion

The basic purpose of our study was to check whether agency cost is low in family firms or non-family firms and to find out impact of firm size, firm age, leverage both types agency cost. For that, we took data of 30 companies that are listed at stock exchange of Pakistan. From results, it has been proved that family-firms have less agency cost as compared to non-family firms in Pakistan. And firm size, age and leverage significantly impacts family and non-family firm's agency cost of Pakistan which becomes evident from our correlation results. Therefore, we will accept hypothesis 3, 4 and 5 that these variables are significantly influencing on agency cost of family firms as well as the non-family firms.

However, this study has following limitations. Sample only included listed family firms from five (5) business groups which are Habib, Kohinoor, Atlas, Dawood, and Nishat and took into consideration agency problem which between managers and shareholders and minority or majority shareholder. Data from time 2008-2016 was set. For further research, more

representative and wide samples can be used which would allow researchers to have better comprehension and understanding of agency cost.

Studying family firm behaviors and aspect is among one of developing fields today. Family owned firms have been identified as playing a fundamental character in world economies with almost having a percentage of 60%--80%.

1- To maintain balance between firm's interest and interest of family members requires people having expertise, dedication and character.
2- With increase in firm age, governance mechanism of the firm becomes strong that helps to reduce the agency cost.
3- Family management should give equal opportunities to all persons and only proficient persons should be hired for the relevant post in case of non-family firms. This will help to reduce agency cost as well.
4- To mitigate the agency cost, an effective governance mechanism should be ensure though certified and professional accountants.

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