

The Relationship of Agency and Performance in Family Business: Small and Medium Enterprise in Yogyakarta

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Abstract

The purpose of this research is to determine the effect and the relationship between controlling mechanism variables and family business performance. This research uses 20 small and medium size family businesses in Yogyakarta as the sample. The controlling mechanism variables used as the independent variables are insider ownership, debt policy, and dividend policy. The other independent variable that is not included as the controlling mechanism is business size, operating profit, and business risk. The dependent variable used in this research is the business performance which is proxy by Tobin's Q. The multiple regressions used to test the effect of independent variable toward the dependent variables simultaneously and individually. The result of this research can explain the insider ownership, debt policy, and dividend policy which significantly affect business performance in simultaneously and individually. This research also found that business performance has positive relationship with those three variables.

Key Words: *Good Corporate Governance, Agency Conflict, Tobin's Q, Family Business.*

Introduction

In general, family business is different with non-family business especially in its complexity and in its management. However, family business has similar goals with non-family business. Family business has higher complexity than non-family business. The complexity is more likely because family business has to accommodate three integrated system, which is family system (family first business), management system (management first business), and ownership system (ownership first business). Which system is the priority will depend on the vision of the company's owner.

Family first business system emphasize on the fact that the company was built for the family business. Family interest is the main concern, which is why the decision made that will affect the future of the company will depend on the family. The management first business emphasizes more on the business interest than the family interest. The performance of the working family member will be evaluated with those who are not from the family member. The leadership is hold by professional not from the family. The ownership first business system describe the existence of the business is not the main concern, but the return on capital will be the main concern. The company is built or bought which later on be transferred to the other owner as long as it is profitable for the family.

The family business that uses management first business will have conflict of interest among the owner and the management, which usually called agency problem. Jensen and Meckling (1976) describe that agency relationship as a contract between the owners (principal) with the management (agent). The criterion of this agency relationship is there is a distinction between the owner and the management. The agency problem

can be minimize by implementing good corporate governance (CGC) or by having several controlling mechanism such as the policy to increase the use of debt, insider ownership, and dividend payout.

According to Jensen and Meckling (1976), Jensen (1986), Crutchley and Hansen (1989), Chen and Steiner (1999), and Morck and Yeung (2003), the increase in debt could decrease the agency problem between the management and the owner. The debt could reduce the excessive cash flow. However debt could also reduce the cash flow because the business has to pay interest and principal. When the cash flow decline, the free cash flow will also decline. This situation limits the desire of the management to use free cash flow to increase their income.

The advantage of increasing the insider ownership is to increase the interest fitness between the management and the owner. The insider ownership arises when the owner also act as the manager. Therefore, the greater the level of insider ownership that a business has the greater the fitness level and the level of controlling the management and the owner's interest (Jensen and Meckling (1976), Singh and Davidson (2003), and Maury (2006)). The management will have the decision based on the owner's interest if they have the proper incentives (Agrawal and Mandelker, 1987).

The increase of dividend payout ratio policy could decrease the agency problem among the management and the owner (Myers and Majluf (1984) and Borokhovich, Brunarski, Harman and Kehr (2005)). The fund which is used to pay the dividend need to be replaced so that the petty cash will always be available. The connection between the three variables with reducing the agency problem is the controlling mechanism can be done to each variable individually and simultaneously. Kim and Lee (2003) and Maury (2006) describe that the decreasing agency problem could increase the business performance. Several empirical research by Morck, Shleifer, and Vishny (1988), McConnell and Serves (1990), Agrawal and Knoeber (1996), and Chen and Steiner (2000) uses Tobin's Q as the instrument to measure the business performance in term of agency problem. Based on the explanation above, this research uses empirical analysis to study on how to reduce the agency problem in small and medium family business (SMFB) in Yogyakarta, Indonesia. The purpose of this research is to find the influence of debt policy, insider ownership, and dividend policy simultaneously and individually towards family business performance.

Literature Review and Hypothesis

Good Corporate Governance

GCG according to Forum for Corporate Governance in Indonesia (FCGI) is a set of regulation to control the relationship between the owner (shareholder), business management (manager), creditor (debt holder), government, employee, and other internal and external stakeholder in relation to every rights and obligation. According to Organization of Economic Cooperation and Development (OECD), GCG is a set of interaction between business management, shareholder, and other party that has interest to the business. In brief, GCG is a system to control the business to achieve its desired target. The purpose of GCG is to create added value to the stakeholder.

Family Firm or Family Business

Family business is defined by Donnelley (1964) as *an organization is called family company if there are at least (must have) two generations in the family are involved and have decision power in influencing company's policy*. Donnelley (1964) theory who is supported by Bebchuk, Krookman, and Triantis (2000) describe that the founder or even the founder's family still has the control in running the business, where the founder's family ownership has to have the largest percentage of shares compared to other shareholders. Sharma, Chrisman, and Chua (1997) confirm that family business ownership and leadership succession are those which have been going for at least from first to second generation. The family business founder is hoping that the following generations such as their children, grandchildren can maintain

the family business to keep running. Morck and Yeung (2003) explain that only 30% of the family businesses are still able to operate until the second generation and only 10% of the family businesses are able to maintain in the third generation.

The Agency Relationship

Jensen and Meckling (1976) said that agency problem will rise when the management own less than 100% of the business share. This situation made the management to allocate part of their cost of managerial decision as for their own interest to the other shareholder (Yong, 1997). This indicate when the management made a decision relating to the owner's interest, then the cost generated from the decision is burdened also to the shareholder as the owner of the business. The agency problem in family business also being studied relating to the effect of family business founder to the agency problem in determining the Chief Executive Officer (CEO) and the business review after the fall of business performance (Chen, Cheng, and Dai, 2006). Their research also found that the greater the agency problem in the business led by family member indicates that the performance is poorer than non-family business.

The Controlling Mechanism in Agency Problem

Jensen and Meckling (1976) shows that agency problem can be minimized by providing incentives to control the managerial ownership (insider ownership) and as a bonding to the management. The bonding mechanism is created by increasing the dividend payout and the number of debt. This action could reduce the opportunity of the management to differ which will increase the business value. However, this method will generate cost that will reduce the business value which usually called agency cost. Bathala, Moon, and Roo (1994) simultaneously test the dependency of insider ownership and the debt policy as the endogen variable, while the institution ownership and other variables such as return volatility, intangible asset procurement, asset growth, and managerial ownership as the exogenous variable. the dividend policy which usually used in the mechanism to reduce the agency problem is not being research. Bathala, Moon, and Rao (1994) research found that insider ownership could help to fit the interest between the non-management shareholders and insider ownership. The main contribution of their research is that the increase in insider ownership could reduce the agency problem.

The Relationship Between Agency and Business Performance

Insider ownership could adjust the interest of the management and the owner to fit. The fitness of the interest creates suitable work environment that the management will be easier to reach the business goal which is the increase in business value (Jensen and Meckling, 1976). This will generate positive relationship between managerial ownership and the business performance. One of the methods to measure the business value is by using Tobin's Q which is first introduced in 1969 by James Tobin as the business investment forecast.

Tobin's Q shows the added value of the business to the shareholder from the asset under owner's supervision. According Pomerleano (1998), Tobin's Q shows the concept of growth and business performance opportunity. The growth opportunity concept focuses on the market expectation toward future project value expected by the management. The business performance concept shows the measurement of business performance towards the assets used to acquire the expected target return.

Morck. Shleiver, Vishny (1998) found the effect of positive alignment and the effect of negative entrenchment on business value which is proxy by Tobin's Q. Harjito (2006) uses Tobin's Q as a business value proxy to see the interrelation between controlling mechanisms of agency problem in the companies in Malaysia. The result of the study indicates if the interrelation occurs in the controlling mechanism of agency problem (policy to increase the insider ownership, debt, and dividend), then the business performance will increase.

Hypothesis Development

Based on this research objective mentioned on previous explanation, then several hypothesis are proposed in this research:

- H1: The insider ownership, debt policy, and dividend policy simultaneously affect the business performance significantly.
- H2: Insider ownership significantly affects business performance.
- H3: Debt policy significantly affects business performance.
- H4: Dividend policy significantly affects business performance.

Research Methodology

Population, Sample, and Data Collection Method

The population used in this research is all SMFB in Yogyakarta which operates since 2001. The target sample used is 20 samples. Survey and interview are the method used in sampling and data collection. The sampling method used in this research is purposive sampling, where the criteria are the business management has been running minimum for two generations and the majority ownership are owned by the family. Those criteria will differentiate between family business and non-family business. The majority of family businesses are managed by their children with or without supervision of the founder. However, there are also found that family businesses are managed by professional or other which are not part of the family member. The data used are those businesses that have been running for ten years which is from 2003 to 2013.

Data Analysis Method

Several analysis used in this research is descriptive statistics, classic assumption test, and hypothesis testing. Descriptive statistic is used to describe data by seeing the mean, maximum, minimum, and standard deviation. Descriptive statistic is implemented to ease in understanding the research variables. The classic assumption need to be done as the term used in regression analysis. The hypothesis testing uses F test to test the simultaneous effect of independent variables toward the dependent variable and the T test to test the individual effect of independent variables toward dependent variable. In this research, there are more than one independent variable, therefore the regression analysis used is multiple regression. The regression equation used in this research are as follow:

$$TOBIN = \alpha_1 + \beta_1 IOWN + \beta_2 DEBT + \beta_3 DIVD + \beta_4 SIZE + \beta_5 PROFIT + \beta_6 RISK + u_1$$

Explanation:

- α_1 : Constanta
- $\beta_1 \dots \beta_6$: Coefficient
- u_1 : Error

- TOBIN: Tobin's Q; equity market value plus total debt) divided by total asset value
- IOWN : Insider Ownership; the ratio of total shares owned by the management with the owner
- DEBT: Debt Ratio; the ratio of total debt (long term debt and short term debt) with total asset
- DIVD : Dividend Policy; the ratio of dividend with net profit
- SIZE : Business Size; logarithm of total asset
- PROFIT: Operation Profit; the ratio of operation income with total asset
- RISK: Business Risk; the standard deviation of income volatility for ten years

Analysis

Descriptive Statistics

TOBIN variable on table 1 shows that all the research samples have the value greater than 1, this indicates that family businesses have good performance. While the variable DIVD indicates that family business has limitation in distributing dividend or net profit sharing to the shareholder with minimum limitation of 10 % and maximum of 50%. The average debt ratio of family businesses is 19-20%, shown by the DEBT variable. The management that has insider ownership value (IOWN) of 1 indicates the owner act as the management and has the 100% ownership of the business share. Moreover, the PROFIT variable shows that the family businesses able to collect operation income by 10% to 50% of the assets.

Table 1 : The Research Result of Descriptive Statistic Variables

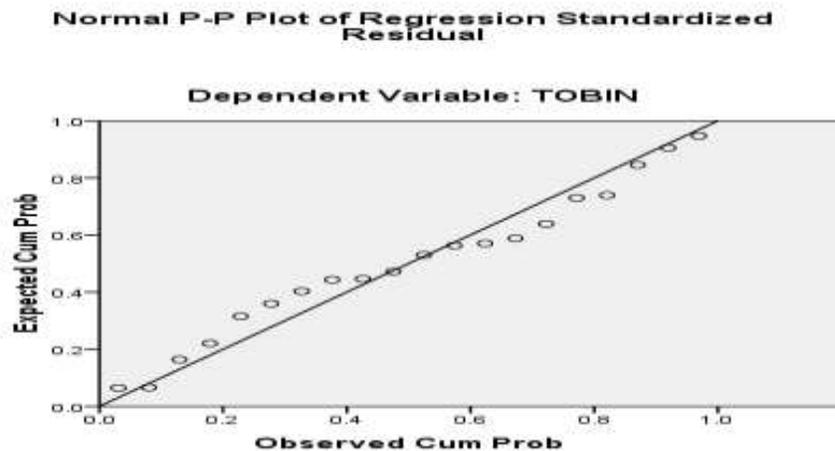
	N	Minimum	Maximum	Mean	Std. Deviation
TOBIN	20	1.0225	1.4788	1.216290	.1361738
IOWN	20	.0700	1.0000	.672350	.3467533
DEBT	20	.0110	.3100	.193640	.0884119
DIVD	20	.1000	.5000	.350000	.1404129
SIZE	20	8.9395	11.1761	10.270905	.5958446
PROFIT	20	.1031	.4923	.287385	.1355963
RISK	20	.8854	1.8010	1.213260	.1850917
Valid N (listwise)	20				

Classic Assumption Test

Normality Test

A regression model can be used to provide better statistical result (BLUE= *Best Linear Unbiased Efficient Estimator*) if it can fulfill several classical assumption. One of the classical assumptions used is the normality test, such as in figure 1, which indicates the data distribution (the circles) around the diagonal line and along the direction of diagonal line, then the data normality assumption are satisfied.

Figure 1. Normality Test Result



Multicollinearity Test

The next classical assumption is the multicollinearity test. Multicollinearity test is used to identify the correlation among the independent variables within the regression model. If there are any correlations among the research variables such as IOWN, DEBT, DIVD, SIZE, PROFIT, and RISK the tolerance value will be greater than 0.10 and the VIF value is below 10, which indicate no multicollinearity among the independent variables or the multiple regression model can be applied.

Table 2: Multicollinearity Test Result

Model		Collinearity Statistics	
		Tolerance	VIF
1	IOWN	.809	1.237
	DEBT	.127	7.884
	DIVD	.672	1.487
	SIZE	.709	1.410
	PROFIT	.131	7.605
	RISK	.408	2.453

a. Dependent Variable: TOBIN

Autocorrelation Test

Table 3. describes that the regression model does not have autocorrelation (DW value = 1.986) because the value are in between -2 and +2 interval.

Table 3: Autocorrelation Test Result

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Durbin-Watson
1	.980 ^a	.960	.941	.0329512	1.986

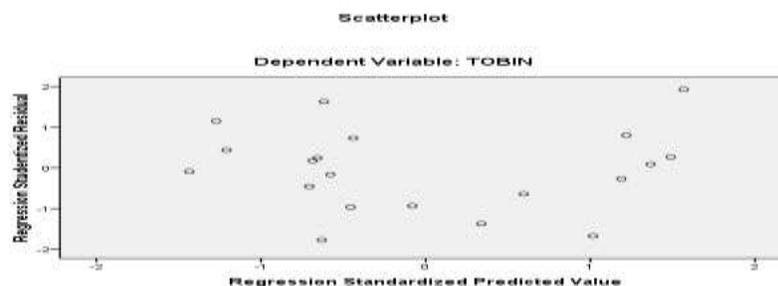
a. Predictors: (Constant), RISK, IOWN, DIVD, SIZE, PROFIT, DEBT

b. Dependent Variable: TOBIN

Heteroscedasticity Test

A good regression model does not generate heteroscedasticity. To know the regression generates heteroscedasticity or not, it can be seen from the scatterplot graphic pattern. Figure 2 indicate the points are scattered above and below zero of Y axis. This term explains that the regression model does not generate heteroscedasticity.

Figure 2. Heteroscedasticity Test Result



Hypothesis Testing

In this research, multiple regressions are used to identify the effect of debt policy, insider ownership, and dividend policy to the business performance. The independent variables used are DEBT, IOWN, DIVD, RISK, PROFIT, and SIZE as the control variable. The business performance uses TOBIN measurement as the dependent variable.

Coefficient of Determination Test (R²)

Based on table 4, the adjusted R square value is 0.941 which indicate that the variable variability of the business or TOBIN able to explain for 94.1% of the dependent variables such as RISK, IOWN, DIVD, SIZE, PROFIT, and DEBT. The rest 5.9% is explained by other variables that are not counted in the regression model.

Table 4: The Coefficient of Determination Result

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Durbin-Watson
1	.980 ^a	.960	.941	.0329512	1.986

a. Predictors: (Constant), RISK, IOWN, DIVD, SIZE, PROFIT, DEBT

b. Dependent Variable: TOBIN

Thoe Simultaneous Significance Testing (F Test)

The F test is used to test the effect of independent variable simultaneously to the dependent variable. The null hypothesis (H₀) states that all independent variable on the model does not affect simultaneously to the dependent variable, while (H₁) states that all independent variable has significant effect to dependent variable. The regression test indicate the significance value of 0.000 which is lower than 0.005 (α = 5%). The results explains that the research hypothesis is accepted, which means that the debt policy, insider ownership, and dividend policy are simultaneously affect the business performance. (see table 5.)

Table 5: The Result of Simultaneous Significance Testing

Model		Sum of Squares	Df	Mean Square	F	Sig.
1	Regression	.338	6	.056	51.915	.000 ^a
	Residual	.014	13	.001		
	Total	.352	19			

a. Predictors: (Constant), RISK, IOWN, DIVD, SIZE, PROFIT, DEBT

b. Dependent Variable: TOBIN

Significance Test for Individual Parameter (T Test)

T test is used to identify the effect of each independent variable to dependent variable. The result might either be negative or positive from each independent variable coefficient. By using t test, it can be found the relationship of each independent variable with the dependent variable either positive or negative. Moreover, it can also be used to identify the coefficient value of each independent variable. Table 6 describe as follow:

1. By identifying the coefficient of each independent variable, then the regression equation will be as follow:

$$TOBIN = 1,110 + 0,010 IOWN + 0,270 DEBT + 0,010 DIVD + 0,012 SIZE + 0,889 PROFIT - 0,073 RISK$$

2. IOWN, DEBT, DIVD, SIZE, and PROFIT variable have positive (+) affect towards business performance (TOBIN). RISK variable on the other hand has negative effect (-) toward business performance (TOBIN).
3. IOWN, DEBT, DIVD, and PROFIT variable found to significantly affect TOBIN because the significant value of independent variables are below 0.05 or 5%. Based on those research results, then H₂, H₃, and H₄ is accepted.

Table 6: Individual Significant Test Result

Model		Unstandardized Coefficients		Standardized Coefficients	T	Sig.
		B	Std. Error	Beta		
1	(Constant)	1.110	.154		7.206	.000
	IOWN	.010	.024	.025	.397	.048
	DEBT	.270	.240	.175	1.125	.031
	DIVD	.010	.066	.010	.155	.029
	SIZE	.012	.015	-.053	-.798	.439
	PROFIT	.889	.154	.885	5.783	.000
	RISK	-.073	.064	-.099	-1.134	.277

a. Dependent Variable: TOBIN

Discussion

Based on the result of the data analysis, insider ownership, debt policy, and dividend policy are significantly affect business performance based on Tobin's Q. The three independent variables also found to have positive effect towards dependent variable simultaneously an individually. If the insider ownership variable is increased, it can also increase the business value. This result support the Morck et al. (1988) research and McConnell and Serves (1990) research that describes the suitability between management and the owner or shareholder can be increased if the insider ownership grew larger.

The greater the insider ownership will increase the management performance in achieving the higher business value as the business goal. In the SMFB in Yogyakarta, the majority of insider ownership is greater, because they feel more comfortable or trustworthy if the business management is held or controlled by the family. Not many SMFB are managed outside family members.

Only a few number of SMFB has no debt. Most of them have debt on banks to finance the business flow. Moreover, most of the owner has already knows their maximum capacity of debt ratio that they can have from bank credits. National or local size banks provide maximum debt ratio of 35%. Based on table 4.1 on DEBT variable, the maximum debt ratio is 31% or no one exceeds the limit of 35%. The first generation of ownership or usually the parents are always have conflicts with their children when the children are the one who manage, because they usually uses the free cash flow for personal use without their parents notification. The lifestyle of their children is much different than their parents or likely to be more consumptive. To overcome the conflict, usually the business owner will increase the level of debt to limit

the owner's desire to use the business cash flow. The fund raised from bank will be used for future investment to provide positive return. Therefore, the increase policy in debt could also increase the business performance, especially in SMFB. This research result also support Jensen and Meckling (1976), Chen and Steiner (1999), and Morck and Yeung (2003) research which found the increase use in debt could decrease the agency problem between the management and the shareholder. This theory also works on not only big and public businesses but also SME businesses either family or non-family businesses.

SMFB always saves their profit for 50% to insure their business sustainability. The rest of the profit for 10-50% (see table 4.1 in DIVD variable) are distributed among the family member as the shareholder. As the management and also as the owner, they usually try to maintain and develop their family business to always uphold the family first business concept. The family harmony determined the existence of the business. Therefore, to avoid any conflict in the family, the dividend is distributed according to the shares ratio. Hence the dividend policy significantly affects the business performance, because there are connection between family harmony and business support.

Conclusion and Recommendations

This research found that insider ownership, debt policy, and dividend policy affects family business performance simultaneously and individually. The three policies have positive impact on family business performance. Family business performance tends to increase the insider ownership until the business is completely controlled by the family. The management and the owner if they did not have the same goal will tend to have the increase in debt policy. In the family business, the life style of founding generation is different with the succeeding generation. Therefore, to reduce the founding generation wariness towards the succeeding generation, they increase the debt policy. The profit sharing from the family business should prioritize the fairness principle among the family member. The profit sharing fairness will sustain the family harmony and it will impact to their business. Therefore, the contribution from each member of the family will determine the dividend proportion. This research recommends the future researches to increase the number of samples and to add more dependent variable other than Tobin's Q as the measurement of business performance.

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