# Chapter II
# Literature Review and Hypothesis Development

There are three topics of literatures to be reviewed in order to develop the hypotheses. They are the characteristic of family firm, controlling shareholders, and the determinants of board structure. Characteristic of family firm provides the insights on family's special contributions in the business. Type of controlling shareholder is one of the factors that have impacts on firm's corporate governance. There are three topics of the determinants of the board structures discussed, which are scopes of operation hypothesis, monitoring and agency cost, and board leadership. After the literature review section, I will draw the discussed studies to develop the hypothesis on the family firms' board structures determinants.

## 2.1 Characteristic of Family Firm

The general definition of family firm is the firm which is controlled by one or more family through ownership and management. Family is a special block holder that affects the firm's characteristics and norms. These special characteristics can be both advantages and disadvantages to the firms. Bertrand and Schoar (2006) have summarized advantages of family firms into four topics. They are the long term commitment, trust, human capital, and politics. First, the long term commitments are formed by the family has put their reputation and wealth with the company. James (1999) supports that the presence of family ownership in firm, guarantee the stability of business and long term planning with the commitment and love fort the business. Anderson and Reeb (2003) support the argument that extended horizons, family loyalty and concern over the family reputation is a strong incentive to ensure the firm profitability. The example for the long term commitment can be shown by of John Walton prospective to Walmart (Weber and Lavel, 2001): "We view [the company] really more as a trust, as a legacy we are responsible for rather than something we own."

Second, the family firm's trust within family members can be a substitute for missing governance and contractual enforcement, which is the second best solution for the weak legal system. Burkart, Panunzi, and Shleifer (2003) assert these ideas why family firms try to preserve

the control of the company, which some situations are optimal to do so. Amenity Potential, reputation benefit, and the possibility of expropriation of outside investors are the three reasons. They argue that if minority shareholders protection is weak, the founding family must stay on the ownership and run the firm because of the high cost of monitoring. Chami (1999) supports that family firm is fundamentally different from other firms as the trust play the important rule. When trust is obviate, there is no need for monitoring and performance based wage, and the performance is highest.

Third, human capital can be created by the family involvement and high correlation of managerial talent within the family. Family member may receive the special exposure to the business since they are young; thus, they have developed their skill and knowledge even before becoming formally involved in it.

Forth, political connection benefit is an important reason. There are the studies (Fisman, 2001; Faccio, 2006) that private firms can be benefited from the political connection especially in economies of high corruption. This is one of the reason also why family try to preserve the control of the company. When the reputation and wealth of family attracted in the company, the benefit in dealing with the political system can create more private benefits for the family.

From those reasons, family firms are believed to have low agency problem within firm because of the align incentive of ownership and management. Fama and Jansen (1983) suggest that family involvement reduces agency costs and help to improve monitoring of the firm's managers. Wiwattanakantang (2001) suggests that family members, who are active managers, have incentives to increase the firm's value and be good monitors because their wealth, both from their shares of the companies and salary, is linked to the continuation of the companies. The implicit forms of contract among family members, such as the responsibility toward the family, may discourage owner–managers from abusing their power and transferring corporate funds to themselves all of these papers suggest that the family firms require less monitoring from outsiders because of the characteristics of the family control.

However, there are also disadvantages of family firm. Culture and reputation of the family may harm itself. Nepotism is high in the family firm. The founder who has ultimate power might hire the manager due to the kinship rather than the more talented manager. The will to restrain a family legacy at all cost that ensures the survival might not align with the shareholder maximization objective. This fear over the lost in legacy of the family might prohibited the family in taking action of the best long run strategy such as expansion or merger strategies. Bertrand, Johnson, Samphantharak, Schoar (2008) show that the availabilities of the founder's son lower the value of the firms. In addition, in the absent of the founder, the number of the sons means the higher of the company's resource extracted by each son.

In conclusion, family has special contributions to the company. They can be positive and negative. Nevertheless, family block holders provide a firm with long term commitment as they tied their reputation and wealth into the company. To some extents there are arguments on the premium value of the family contributes to the firm as there is no clear studies to show which characteristic of the family firm contribute to this value. In the nutshell, the important roles of the family firms are that they reduce the agency problem between shareholder and manager. They have in-depth firm specific information, and they are good monitors. This characteristics should be formed by their corporate governance; thus, family firms should have different determinants of board structure than others type of firms.

**2.2 Controlling Shareholder**

Controlling shareholders mean the shareholder parties who have high stake in both cash flow and voting rights of the firm. The controlling shareholder will have great influence in the firm. For example, the controlling shareholder can select or fire the management team and director of the company. Controlling shareholders can benefit themselves with the company's cash flow by giving the position on board to their relatives or paying out more dividends. This significant control over the company rise both cost and benefits. The presence of the controlling shareholder mitigates the free rider problems of monitoring the management team that reduce the agency problem (Shleifer and Vishny, 1986). This is because the large shareholders have incentive to take the monitoring cost as the gains of monitoring are exceed the costs. The

controlling shareholder can be defined by the character of the shareholders. It can be family, government, financial institution, and foreigners. Each type of the controlling shareholders brings unique influence to the firms. As discussed earlier about family involvements can reduce agency costs, longer operation horizons, and create special culture in the firm. Government controlled firms are another special type of firms. Government controlled firms usually operate in a monopoly or regulated industry. These regulated markets such as transportation, energy, and communication are important to the social welfare of the citizen. In these firms, government entities will hold approximately about half of the total shares. Thus, it is partly government and public entity. It is important that the company must have great monitoring and advisory from the board director to ensure the sustainable contribution to the society. Financial institution controlled firms are mainly controlled by bank, insurance, fund, and security companies. These institutional shareholders have restricted rules to monitor for investor protection (Shleifer and Vishny, 1997). Cheng, Huang, Li, and Lobo (2010) prove that litigation is effective disciplining tool for the institutional owner to monitoring and improve the corporate governance of the company. Black and Coffee (1994) argue that institutional investors with above average investments tend to be more active in the governance. With the unique set of characteristics, it is necessary to investigate the board structure determinants of each types of controlling shareholders.

### 2.3 Determinants of board structure

The determinants of board structure are influenced by the characteristics of the firm, types of the influenced shareholder, and the culture of the firms. Thus, shareholder is another concerned element. Gillian and Starks (2000) show that long-term shareholders generally are more interested in building a strong governance systems. Board structure consists of inside and outside directors. Insiders, who are also in the management team, have rich firm-specific information (Fama and Jensen, 1983). Nevertheless, inside director in the board can increase the agency problem in the firm. While outsiders are more independent of the CEO; thus, they are better at monitoring. Outsider can also bring new information to the board. CEO who rewards the chairman of the board position has significant implication. Chairman of the board has absolute power to control of the board agreement. Thus, CEO with COB can increase the agency

problem in the firm, which they have both managerial and shareholder control. The studies of firm characteristics and board structure can be summarized in three sections.

*2.3.1 Scope of operation*

The scope of operation theories suggest that board size and board composition relates with the numbers of business segment, firm size, firm age, and leverage. Suggesting by Fama and Jensen (1983), Dalton, Daily, Johnson, and Ellstarand (1999), and Coles, Daniel, and Naveen (2007) that the compositions of board of director are driven by the complexity of operation, the board size and board independence should be positively related to the firm size, age, and number of segments. This is because more independent directors and the larger board size bring more knowledge and experience to help the management team. The relationship between firm size and age to the larger board are explained by a rising in the demand for the specific knowledge as the firm grows. With the same rationale, numbers of segment represent the number of business operation. The more business segments the firms have, the more knowledge the firms are required from the board of directors. It is positively related with the number of independence director and board size. Firms with high leverage depend on external resources to a greater extent and could have greater advising requirements (Pfeffer, 1972; Klein, 1998). The additional directors might have a specialized knowledge to fulfill this new growth area (Bhagat and Black, 1999). Moreover, Hermerlin and Weisbach (1988) argue that the CEOs of the diversified business have more demand for advice, which directly support the statement that board size should be positively related to scope of operation variables.

*2.3.2 Monitoring cost, Agency problem*

One duty of the board of director is to reduce the agency problem between shareholders and management team. Board of director monitor the management to make sure that their practice maximizes the shareholder value. Nevertheless, two types of board directors have pros and cons in their nature. Harris and Raviv (2008) find that there is another agency problem between outside and inside directors. This is possible because inside directors may not want to give all information available to outside director for their private benefit. Moreover, this problem

may create high cost in monitoring the management team. Another monitoring cost arises from the special or complex information of the company that is difficult to transfer to the outside director. Outside director may not have enough understanding about the business. The firm with high R&D expenditure with specific knowledge is such an example. This statement support by Raheja (2005), which suggests that the most effective optimal boards are those with low verification cost to outside board member and low private benefits to inside board members. Thus, the firms whose outside directors find it difficult to verify the project optimally have higher proportions of inside directors on the board.

Further, Coles, Daniel, and Naveen (2007) support the idea of Raheja (2005) that the proportion of inside directors will be positively related to the firm's R&D expenditure because outside board members are ineffective in monitoring. This confirms the studies of Fama and Jansen (1983) that inside directors provide more firm-specific information. Jansen (1986) argues that free cash flow generates agency problem, which require the board to monitor the management team. Harris and Raviv (2008) discuss that outside directors must exert effort to apply their expertise; thus, when the number of outside investor increases, each outsiders view the value of their effort has been reduced. That is the increase in outsiders aggravates free rider problem. Board size and board independence are positively related to the managers' private benefit and negatively relative to the monitoring cost. They also find the interesting agency problem between insider and outsiders. If inside directors contain firm specific important information, giving control to outsiders may create a loss of information. Nevertheless, if there is large agency cost, the independence board control is optimal. This shows that the pros and cons of marginal director depend on the firm characteristic. It concludes that board size is positively related to agency problem variables while it is negatively to monitoring cost variables.

*2.3.3 Board leadership*

Brickley, Coles, and Jerrrel (1997) argue that CEOs are awarded the chair man of the board position as promotion or succession process. Brickley, Coles, and Linck (1999) support that the successful CEOs are likely to remain as COB (chairman of the board) title on the board after they retire. This happens because the CEOs have valuable firm-specific information that is

necessary for the firm success. Linck, Netter, and Yang (2008) predict that the CEO and COB posts are combined imminence of the CEO's retirement, the CEO's perceived ability, and information asymmetry. For the family business, the CEO can be from the founder family or hired CEO, whom the family trust or have a good relationship with. This would reduce the agency cost between the decision agent and residual claimants. Moreover, the present of the dual role is strengthening the leadership of operation. The CEO, who has well firm specific knowledge, can implement the decisions faster.

In summary, the firm characteristics are the factors to the determinants of board structures while different types of firms also have affected to their board structure. The scope of operation, monitoring and agency cost, and board leadership are the hypotheses of determinants of the board structure. In the following section, the study forms the hypotheses on the board structure in family firms and nonfamily firms.

### 2.4 Hypothesis Development

Family firms have special characteristics comparing to nonfamily firms as they have different value and norms in the companies. Family firms are believed to have lower agency problem and there are higher cost for outsider to monitor the firm. The number of board members and compositions are composed to maximize those duties of advisory and monitoring. As the result, different firms' characteristic should result in different board structure. With the contribution of the literatures review above, I conclude three hypotheses as below:

**Hypothesis1: Family firms have smaller board sizes than the nonfamily firms.**

The family firms have the aligned incentive between shareholder and management, and higher cost of monitoring; thus, this reduces the cost of monitoring managers. While family firms still need the advisory from the boards, there is less need for the number of directors to monitor the manager. Thus, I form the hypothesis 1 that family should have smaller board members as the agency problem are less, which require less monitoring function from the board of directors.

**Hypothesis2: Family firms have less proportion of independent directors than the nonfamily firms.**

As family firm's characteristics reduce agency problem and improve the monitoring quality, it would be unnecessary to have many independent directors. Inside directors are important sources of firm specific information while outside directors provide good monitoring role. Hypothesis 2 asks whether those family firms have less board independence than the non family firms. There are many literatures support this hypothesis. Mishra, Randoy and Jenssen (2001) suggest that outsider may not help creating value in the family firms. Rosenstein and Wyatt (1997) suggest that when managerial and outsider shareholder interests are closely aligned, the benefit of an inside directors' specific firm knowledge is outweighs the expected cost of managerial entrenchment. This is aligned with Harris and Raviv (2008) which shows that it is optimal to have insider control of the board as it reduce the agency problem between insider and outsider directors.

**Hypothesis3: CEOs of family firms have dual role more than those of non family firms.**

The theories from the board leadership and family characteristics suggest that the CEOs in the family firm are likely to have higher chance to hold the dual role position more than in the non family firms. The family business environment trust plays an important role and that board leadership brings the CEO with faster decision making process. The family firms should provide this special position to the CEO more often than the non family firms.