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Family involvement, internal control and agency costs — Evidences from China's listed family firms☆

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Summary This study examines the agency costs of 314 family firms listed on Shanghai and Shenzhen Stock Exchange in China. The results show that agency costs of family firms increase significantly with the enhancement of family's ownership and the separation of ownership and control, while family involvement in management can reduce the agency costs. By including the variable proxying internal control and the interaction term between internal control and family involvement in the empirical model, we still find that the effects of family involvement on agency costs are contingent on the quality of internal control.

Introduction

Family firms are the most ancient form of organizational structure, and play an important role in the modern economic life. Approximately two-thirds of private businesses are family owned over the world (Neubauer and Lank, 1998). In the ***Fortune*** global 500 companies, 175 firms are controlled by family. Since the reform and opening up, China's family firms have experienced unprecedented development. According to the latest statistics released by the State Administration for Industry and Commerce of China, the number of private enterprise dominated by family has exceeded 10 million by the end of 2014, accounting for more than 60% of China's GDP.

Family firms are linked with blood relationship and kinship ties. In light of classical agency theory, such a guan-xi culture is helpful to alleviate the interest conflict within the firm and reduce the agency costs. Therefore, family firms are considered the most efficient forms of organization (Fama and Jensen, 1983a; Daily and Dollinger, 1992). However, Schulze et al. (2001, 2003) challenge the classical agency theory. They argue that family firms may be subjected to higher agency costs because of conflicts associated with private ownership and owner's self-control, as well as those posed by asymmetric altruism, so that the performance is rather lower than that of non-family firms.

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This study contributes to the literatures on agency problems within family firms in the following ways. Firstly, most researches treat family firms as a homogeneous group, ignoring the difference in the way that the controlling family may influence a firm. Following the approach of Villalonga and Amit (2006, 2009), this study takes into account the differences in family firms by distinguishing among three fundamental elements in the family involvement, namely, ownership, control, and management. Secondly, in a social context in which family takes on particular meaning, we are able to investigate the influence of traditional Confucian values on the agency costs in Chinese family firms. The unique sample not only fills the empirical void for emerging markets but also enriches the understanding of the sector. Finally, considering the characteristics of China's Accounting Standard and the availability of data, we use perquisite consumption and inefficient investment as two new proxies for the agency costs.

The remainder of the paper is organized as follows: In the next section we present the theoretical analysis and develop our hypotheses. We then detail the methodology in the third section. We present the empirical results and discuss the implication of our findings in the fourth section. Finally, we conclude the paper with its limitations and provide some suggestions for future research.

Theoretical analysis and hypothesis development

Interest conflicts and information asymmetry are the basic causes of the agency costs (Jensen and Meckling, 1976). The classical agency theory documents that the family firms represent one of the least costly and most efficient forms of organization for the following reasons. First, in the family business, ownership mainly concentrates in the family members with blood relationship, such a ''private property'' can ensure the consistency of family agents' pursuit with the interests of the whole enterprise, so as to alleviate the agency tension caused by interest conflict (Fama and Jensen, 1983a); Second, the mutual communication and coordination among family members are more convenient, which help to reduce the agency costs elicited from information asymmetry (Fama and Jensen, 1983b; Daily and Dollinger, 1992). Accordingly, the following hypothesis is proposed:

H1. The agency costs of family firms are lower than non-family firms.

However, family firms are not a homogeneous group with the same sets. Family involvement always differs greatly in ownership, control and management. The controlling family always holds a larger proportion of equity, which can ensure the consistence of interests inside enterprise and reduce the agency costs caused by interest conflicts. But with the expansion of scale, family firms tend to attract external capital. Through the cross-shareholding and ''pyramid'' structure, controlling shareholders can achieve dominant position with less ownership. Such a separation of ownership and control is most pronounced among family-controlled firms (Claessens et al., 2000; Faccio and Lang, 2002). The entry of external capital exacerbates the interest conflicts between the controlling family and other shareholders and exerts adverse effects on the control of agency costs. In addition, family involvement in management is also a key attribute distinguishing family firms from non-family firms. Compared with the non-family managers, family managers tend to view the fulfilment of family business goals as intrinsic. They always subordinate their personal interests to working towards the organizational interests, leading to no or little agency problems (Chrisman et al., 2007; Karra et al., 2006). Accordingly, the following hypotheses are proposed:

H2. Family ownership relates with the agency costs of family firms negatively.

H3. The separation of family ownership and control relates with the agency costs of family firms positively.

H4. Family involvement in management relates with the agency costs of family firms negatively.

While family involvement is common practice in family firms across cultures, its meaning and role is contextual and culture-specific. China is the birthplace of the Confucianism. Confucianism is woven into the very fabric of Chinese society, and contributes distinctive characteristics to Chinese family firms. Confucianism stresses the reciprocal benevolence between persons. Such a reciprocal relationship underpins the family hierarchical order and social harmony in China. In the business context, the benevolence of family business owners towards other members always manifests in the positioning them in senior managerial roles. To return the favour, family managers always display strong psychological allegiance and commitment to the enterprise. Mutual obligation can reduce individual opportunism of family agents' and agency costs of firms accordingly (Kim and Gao, 2013). More importantly, Confucianism promotes filial piety, submission and obedience of subordinates towards superiors, which are likely to induce steward-like behaviour of family manager and contribute to the solution of agency problems (Bell, 2010).

However, Confucian values prevalent in Chinese family firms may also exert negative effects on the agency problems. As mentioned above, the personnel recruitment and promotion of key positions are often made based on family superior's personal preference, rather than formal systems and procedures. It easily leads to the entry of unqualified family members into the business. Even worse are that these people still enjoy the privileges and their behaviours are always beyond the control. In addition, Confucianism stresses the strict ethics and hierarchical order, which easily induce the paternalism of family superior. Owning to the lack of scientific decision-making procedures in many China's family firms, the irrational strategies and inefficient investment decisions are often made by family superior based on individual experiences or judgments, thus exacerbating the agency problems. This is the important reason that many Chinese family firms fail in operation.

Fortunately, with the entry of western management philosophy and the promotion of modern enterprise system by Chinese government, nepotism and paternalism permeating in Chinese family firms have been inhibited to a large