# AGENT-PRINCIPAL PROBLEM, STEWARDSHIP THEORY AND BEHAVIOURAL AGENCY MODEL IN THE EXPLANATION OF FAMILY BUSINESS PERFORMANCE

*Gergely Farkas*

**Abstract**

The paper examines, that there are inconsistent results about family business financial performance. Less agency cost is a plausible explanation when family businesses perform better than non-family businesses. Nonetheless minimizing agency cost through trust and strong social and emotional bonds in the family can lead to lower financial performance in several cases, because control is less strong. This way self-interested goals of family members lead to less good performance of the whole business. So less agency cost is not enough to make a general explanation. In stewardship theory the manager is not self-interested, but a long term oriented altruist. Based on strong social and emotional bonds the manager wants to follow financial and non-financial goals according to the needs of the family. Therefore, in the frame of stewardship theory performance can be lower in several cases, because resources are used up for non-financial goals. Both agency and stewardship theory says managers avoid risks for short or long term goals. In behavioural agency model family business managers is not seen as risk avoiders. Instead they avoid loss even if it means riskier decisions. They preserve the socioemotional wealth of the family, what is the most important capital for them. Family businesses in benign environment can follow long term non-financial goals. However, the manager is able to act as a homo economicus in a hostile environment, when socioemotional wealth is endangered. Behavioural agency model can explain why family business performance measures are inconsistent. In different circumstances family businesses risk tolerance is not static, socioemotional wealth is used as a reference point. So behavioural agency model can predict when will act a family business manager as an agent and raise financial performance to avoid loss. And it can tell us when is the time to follow family goals and let the usually short time oriented financial numbers be less impressive.

*Keywords: agency, stewardship theory, family business, firm performance*

## 1 INTRODUCTION

The goal of this paper is to review the literature of different management behaviour models in family firms. It is important to study how deeply changed the viewpoint of family business management during the decades. Agency and stewardship theories are like opposites of each other. Managers follow only short term goals in the one, and only long term goals in the other. Behavioural agency model is a new theory from the last decade to explain this controversion. With the methods of behaviural economics it can predict the results of decision better than prevous theories.

The literature review is not based on a strict methodology, but it focuses on the managerial behaviour effect on the firm performance. I use the family business and performance as it is in the literature: without a proper definition. Family business is a firm with the major ownership in the hands of a family, or at least under the strategic control of a family. Based on my research expereience even for entrepreneurs it is hard to decide if they are a family business or not. Sometimes they denies, but the managers accepts a successor from the family only. In other cases managers say they have a family business because it is so familiar, despite not a single

relatives works there. Even the literature sees my first example as a family business and the second as a non-family business, it is hard to make this black and white. How many generations far cousins can be founders of a family business? Performance is mostly based on financial measures what makes the results single sided, and the indicators are many and various in different studies. Therefore evidence is often controversial, and definitions vary widely. It would not be a good idea to decide just about number of pro or contra results.

This paper is a preliminary study for a research what me and my collegaues do with qualitative method about family businesses. Our plan is to use it for describing different behaviours based on different theories appearing in the interviews with family business owners, managers and employees. For the readers it is an interesting summary of the above mentioned three concepts and a great journey through different viewpoints of the family business management.

## 2 AGENT-PRINCIPAL PROBLEM

In agent-principal problem two (or more) actor share the risk of decisions, but the attitudes of the actors toward risk can be different. The principal delegates a task for an agent, who does that on behalf of him. But it is not sure that the agent works in behalf of the principal. The connection of the actors is described as a contract. This cooperation is problematic because of two things. Firstly, the goals of the actors can be different because they perceive the risks differently, therefore the preferences of them are not the same. Secondly the price of the controlling is high, or difficult to accomplish for the principal. In the contract the behaviour or the output is the dominant part, what is influenced by the market uncertainty. In the case of lower uncertainty, the output based measurement is preferred. (Eisenhardt, 1989)

The study of agent-principal problem roots in the 1960s, when after the spread of nuclear power plants the people waited for a clean and unlimited energy source, but they realized the risk of catastrophes and the long time environmental pollution. The risk attitude of the people was different from the attitude of science about nuclear power. According to Starr (1969) the people are willing to take a thousand time more risk if they think it is their decision (like driving a car, or starting a new firm), than when the environment forces the choice on them (like nuclear power, or taxation).

Ross (1973) created the mathematical model of the agent-principal problem. Later Jensen and Meckling (1976) introduced the concept of agency cost, what includes the paiments of the agent and the price of the controlling. Even in our days it is an important question, that how can we mesaure this cost, and what kind of effects has an influence on it. In early explanations the information assymetry was in the focus, but it was obvious that personality and attitude are important things with big influence on risk avoidance or risk seeking. In the case of risk handling the personal recreancy is more important than ideological and sociodemographic variables combined according to Freudenburg (1993).

We can think that family firms are risk avoiders. They risk the family wealth, their livelihood, therefore they avoid the risky decisions. But in the same time they are risk seekers, because usually they investment is not diversificated, they have capital in one firm only (Beatty & Zajac, 1994). They follow a conservative strategy because they are interested to keep a constant welfare for the family, what requires to avoid risk until the status quo is safe (Bertrand & Schoar, 2006). The meta-analysis of Hiebl (2012) showed that the risk behaviour of family businesses can be influenced by several not yet studied factros and based on the results so far it is not confirmable that family firms are more risk avoiders than non-family firms. However, Hiebl (2012) notes, that family businesses spend more on insurance, what can be a rational choice because the less diversification (Beatty & Zajac, 1994), and the pursuit of long time persistence (Miller et al., 2008).

The information assymetry has a big influence in the cases where less controll is possible, like in radical R&D investments. According to Gomez-Mejia et al. (2003) the compensation of family business manager is lower in case of R&D investments, because the less assymetry in information. The stronger bonds between family members can ensure better information distribution. Bartholomeusz and Tanewski (2006) also states, that because the well being of the family and the firm are in strong connection, therefore minimizing agency cost in the firm is in the interest of the family because this way they maximize the profit of the whole family.

Other factors can have a strong influence on agency cost also, what is appears in business performance. The performance of family business can increase or decrease because the agency cost (Christman et al., 2004). The direction depends mostly on the good or bad relationship of family members, and the size of the firm. Agency cost appears after different, more distinct roles needed in bigger families and in bigger firms (Karra et al. 2006).

If the agent and the principal is the same person then agency cost can be lower in the family business. Even in this case the agent-principal problem can appear between family members. Though the costs are lower because the high trust and common values. Agency cost declines also when the family members pursuit non-financial goals. For example the knowledge transfer for the next generation, when there is less control over the selection of successor than in non-family businesses. Another example when the family employes a non-productive relative to ensure his livelihood. In this later case control is more relaxed, because the agent is not productive enough to produce more value than his cost. For such cases the agency cost is lower, but the firm performance also decrease. (Christman et al., 2004)

In the case of family conflict the agency cost raises rapidly, because firing a relative is rearly an option. If goals and values are different, than family members compete for strategic control. Different interests appear often if family members connects to the firm in different ways (Dyer, 2006). According to Gomez-Mejia et al. (2001) the business performance gets better in such cases, if family member managers replaced by professional outsiders.

Agency cost also increase when family members do altruistic behaviour. In this paper I use altruism as helping someone for who he/she is, and not because of his behaviour. Altruism lowers effetciveness of control as stated by Greenwood (2003). Family members can trust in altruistic leader behaviour even if they act other way than the superior expects. Therefore the efficiency of the managment decreases. Problems of altruism are avoidable with some management hierarcy inside the family (Schultze et al., 2003). If the roles and processes are well definied than altruism is less needed, but the agency cost incrases in the same time because of the more control. Stowaways can appear without these, and detecting them can be problematic because of the subjective perception of each other within the family.

Agency cost is usually very low or does not measurable during the first generation of the family business. More and more actor appears with the growing of the nuclear family and the firm, what brings in the agent-principal problem. This increases further when nepotism is the base of the succession. If the successor is less suitable for the managment role, than the value of the firm decreases. This declination can be also defined as an agency cost (Herrero, 2011). Family businesses tend to keep management in family hands to keep agency cost low even the successor selection is not ideal because of the nepotism (Lubatkin et. al., 2007), or the founder gets so old that his or her waning management performace influene the firm in a negative way (Shleifer & Vishny, 1989). This is the so called entrenchment phneomenon, what promises more loss of profit than the ammount saved by lower agency cost (Herrero, 2011).

# 3 STEWARDSHIP THEORY

Stewardship theory stands for the above mentioned behaviour patterns. Contrary the viewpoint of the agent-principal problem, where the agent seeks his/her interest like a homo economicus, in stewardship theory the manager has long term goals and sustainable development is important. The goal of the agent is "to do a good job, to be a good steward of the corporate assets" (Donaldson & Davis, 1991, pp. 51). Strong connections between actors is necessary, and they should relate to the same social network. These criteria are usually given in the case of family businesses (Christman et al., 2004).

Donaldson and Davis (1991) emphasize that it is important to give something motivating for the long term for the manager if the manager and the owner cannot be the same person. It is not defined what this long term package can be. It can be a bonus, a target bonus, a share, or something else. In the case of family businesses, the stakeholders do not connect with a formal, written contract to the firm. The head of the family does not promise a better Christmas gift if the firm performs well. However, the members will be loyal to organizational goals, because family wellbeing and honour depends on the firm, (Breton-Miller & Miller, 2009).

Entrepreneurship for the leader is a tool for achieving personal and professional goals. It is peculiarly true for family businesses, where more family members can pursue these goals (Gomez-Mejía et al., 2007). Family business membership has a value, at least a distinctive value in the local community, what also strengthen loyalty (Sirmon & Hitt, 2003). Succession also enhance the long term goals, because in the process not just knowledge and power is transfered, but the manager wants to deliver the firm assets in the best possible state for the successor (James, 1999).

Miller et al. (2008) describe the scientific knowledge about stewardship in family business as a perspective of the organization. They delineate three common forms of stewardship. First is continuity, what ensures the long term survival of the family business for the benefit of the later generations. Second is the organizational culture, what motivates and makes employees a loyal community. Third is the strong connections with outside stakeholders, especially with the customers, because these connections can help to pull through a financial crisis.

Three behaviours connect to the continuity aspect (Miller et al. 2008). First is the long term thinking, what takes in account the interest of the next generation. The less growth orientation, more conservative investment strategy can be the effect of this, meanwhile the family businesses spend more on R&D, and innovation processes. This is because they know these help the long term survival of the firm and they are less shackled by short term financial indicators. Second behaviour is related to the reputation in the market, what also helps the long term stability, because better reputation causes more customer loyalty and helps to keep up the market share. Family businesses give more factual, valid information about they products or services to maintain the reputation of the family. Third behaviour is the building of the market share what also helps to "solidify the business for the future (Miller et al. 2008, pp. 54.).

The community is the second aspect. Most firms try to build a strong organizational culture because a motivated and loyal employee community is good for business, but Miller et al. (2008) emphasize the importance of it in family businesses. Studies what they cite state that these firms organize more training with extensive topics and to make sure that management and employees can cope with the uncertain future problems. Employees has a wider responsibility and role than in the case of non-family businesses. They are flexible in help to find the right employee for the right position, or to create informal communication networks in the firm. They are also tolerant with the work schedule problems and work from home. They accept women in management more easily than non-family firms. This behaviour

is also interesting from the viewpoint of social transaction theory, because the manager can be a model for prosocial behaviour (Pearson & Maler, 2010). The reciprocity based on the following of the model behaviour can lead to a stewardship culture in the organization.

The third aspect is focusing on the outside stakeholders, mainly on customers. Family businesses tend to extend the relationship with the customers. It does not happen just in the time of transactions, and they exchange information not related to the transactions. Because of long term goals they want long lasting relationships too. Miller et al. (2008) mentions many things about this behaviour what is typical of family businesses. The managers of the firm meet the customers more often. This increase trust, what lowers transactional costs. Of course this works only if the manager has some marketing skills. The firm can satisfy personal needs, and alter the offers for these customers. Convenience store is a good example for this: the room is small for a big supply, but based on local customer needs the shop can make an ideal mix of price and quality. This makes loyal customers because they find what they really need close to their home.

Result of stewardship is the collective utility instead of the fulfilling of personal needs (Welsh et al. 2013). While agent-principal problem is less frequent in family business, stewardship is not only a possibility, but it is almost inevitable because the strong social bonds and common values. The perceived stewardship can be different in the case of non-family employees. According to the research of Davis et al. (2010) the family and non-family employees have similarly high loyalty where stewardship exist, but the difference in the favour of family employees is still statistically significant. Non-family employees usually know that a family business manager will prefer relatives even if stewardship culture is strong in the firm.

Stewardship decline and agent-principal problems appear, if strong emotional bonds loosen and values get more and more different. This can happen because of a family conflict, or the generational expansion. There is evidence for the later in the transgenerational study of Breton-Miller and Miller (2009). Dodd and Dyck (2015) uses an unusual qualitative method for creating new theory. They analysed ancient texts to develop new ideas for family business research. They define a business type where stewardship exists, but there are no relatives in the business. This is the universal-family business where stewardship is only based on kinship, but not on family relations.

## 4 BEHAVIOURAL AGENCY MODEL

Agent-principal problem and stewardship theory have limitations when scientists try to verify them. Meta-analysis of Tosi et al. (2000) did not find a significant correlation between the salary of CEOs and the firm performance, however it should be some if agent-principal problem is not just a theory. The level of risk perception is constant in every actor according to the above mentioned theories, while they do not pay much attention for risk seeking behaviours (Kumeto, 2015). Therefore, the behaviour of the actors is rigid in these theories.

Behavioural agency model is based on the results of decision theory. It uses the conclusions of the experiments about the expectations theory to point on the utility of the substitution risk avoidance with loss avoidance. In that case the main goal of the manager is not to maximize the profit in the future, but to keep the existing level of wealth (Wiseman & Gomez-Mejia, 1998). It can lead to a risky behaviour to minimize possible losses in an uncertain situation.

Instead of the constant risk attitudes, the behavioural agency model emphasizes the importance of the framing effect (Tversky & Kahneman, 1986), what states that different varriables have impact on the decision of the agent. Someties the win, sometimes the loss is more important. In the contract of the agent and the principal there is a greater role of intrinsic and extrinsic

motivations according to Pepper and Gore (2015), than the effect of efficiency and profit maximalization. We should note that in general the behavioural agency model has more theory in it, than evidence is available (Pepper & Gore, 2015). Nonetheless it is popular in the field of family business research because of the works of Gomez-Mejia et al. (2007, 2014), who explain the behaviour related to the socioemotional wealth with this model.

Family businesses are interested in preserving their socioemotional wealth, what is not measurable in money, but it includes all the benefits of the social and emotioanl connections in the family business. This can appear in three different way in the behaviour. With keeping the ownership and control in the hand of the family, with nepotism, and with building of the reputation of the family. While building reputation has usually positive consecvences, meanwhile the nepotism can be the source of many problems (Naldi et al. 2013). According to this family firm managers do not decide about how to increase efficiency, but to avoid loss of socioemotional wealth in any situation. This makes this type of wealth a primal referencer point (Naldi et al., 2013).

Socioemotional wealth is connected to the business and to the family, and family members cannot hide from it. Berrone, Cruz & Gomez-Mejia 2012 states that this is the core of the difference between family and non-family firms, because this type of strong connection between family and work life can only exist in family firms. They summarized many empirical study in their paper where the sociemotional wealth level as a reference point influences the decesions in family business. They also notes the situation when firm perfomance anticipate the end of business with a bankruptcy. That time the aspiration level of socioemotional wealth can change to pursue financial goals of the firm for a short time and survive. Chrisman and Patel (2012) found evidence about that in crisis the family businesses spend more on R&D, to ensure long time survival.

Behavioural agency model is useful to explain such idiosyncratic concepts of the field. Familiness describes a unique set of resources of the business and the family and can be the source of competitive advantage (Habbershon & Williams, 1999). If we know the process it worth to measure the variables. What makes a family business unique and how much. Berrone et al. (2012) suggested five factors of socioemotional wealth. First is family control and influence, what can be direct or indirect. Second is the family members' identification with the firm. This causes that the firm works as an extension of the family in the eyes of outsiders. Third is the binding social ties, what also connects to outsider stakeholders. Fourth is the emotional attachment what is a topic without enough research data so far according to Berrone et al. (2012). The emotional life of the family has an influence on business, but we know little about how it works. Finally, the fifth factor can be the renewal of family bonds to the firm through dynastic succession. Zellweger et al. (2012) also describe this as important thing for the family firms. They tend to keep financial and knowledge capital both inside the family during succession.

Naldi et al. (2013) studied the relationship of the protection of the socioemotional wealth and the firm performance. In their results the business environment has a great impact on the effect of such behaviour. It can increase or decrease firm performance under different circumstances. This needs further research because they studied only a limited number of environmental variables.

It is worth to mention here the research of Gomez-Mejia et al. (2014) too, who became to the same conclusion in the case of high-tech family firms. This is interesting because R&D is very important in this industry. Family businesses however invested less in it unless they expected a loss in their socioemotional wealth. In that case they spent more than non-family businesses. This also proves that risk attitude is not constant and impact on financial firm performance can

be various. How this works exactly is still an open question for the future. Profund research needed to describe the connections between the variables. It would be necessary to measure changes in financial assets and socioemotional wealth in the same time. This can be a fruitful research area in the next years.

## 5 DISCUSSION

Agent-principal problem was an important construct for the description of the transactions and the contract between the owner and the manager. In contrary of this construct, the stewardship theory argues, that prosocial behaviours can appear in these connections, moreover it can be beneficial for the actors. It requires some factors what are more frequent in family businesses. But it is not required to choose either the always self-interested, either the always altruistic leader behaviour with the help of behavioural economics. Behavioural agency model can take into consideration the environmental variables and the inner bonds too. It can explain why managers sometimes self-interested, and sometimes altruistic. This model found a fertile ground in the field of family business research, because it clarifies behavioural explanations related to so far idiosyncratic constructs like the familiness or the transgenerational wealth. It is a work for the future to study further the mechanism of this model and to specify the possibilities of measurement. Socioemotional wealth can be a possibility to involve non-financial goals in performance studies in a measurable way.

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**Contact information**

Gergely Farkas

University of Szeged, Faculty of Economics and Business Administration

Hungary, Szeged, Kálvária sgt. 1.

+36702464647

farkas.gergely@eco.u-szeged.hu