

## DO FAMILY FIRMS TEND TO ISSUE SHARE-BASED PAYMENT DUE TO BETTER GOVERNANCE THAN NON-FAMILY FIRMS?

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**Abstract.** *The objective of this study is to explain and provide comparison regarding the issuance of share-based compensation in form of Employee Stock Option Plan (ESOP) in publicly listed family and non-family firms in Indonesia. Previous research regarding the issuance of ESOPs proved that strong corporate governance influences the firm to issue compensation in order to mitigate agency conflict which often occurs in firms with dispersed ownership. However, in a concentrated ownership such as family-owned firms with family members in board members or even family CEO already have their interests aligned. Therefore, issuance of ESOP in family firms may fall to two purposes: rent extraction or long-term value maximizing. A collection of companies listed in Indonesian Stock Exchange issued ESOP during 2013-2018 period is taken as sample. Using panel data regression, corporate governance practices in board meetings frequency has positively affect the grant of ESOPs regardless family or not. In listed family firms' environment, board meetings and independent commissioners each have linear relationship to the grant of ESOP.*

**Keywords:** *Corporate Governance; ESOP; Family Firms*

### INTRODUCTION

In terms of decision making in the company, managers (agent) may face conflict of interests with shareholders (principal), as their interest sometimes may not align with each other, this problem incurs cost that is caused by an ineffective firm decision-making process, which is known as *agency cost*. To reduce the conflict, compensation to managers and employees become the option. Stock-option plan as the efficient compensation tools to align managers and owners' interests and maximize shareholder value (Zattoni, 2007) by giving the managers the rights to be a partial owner thus encouraging managers to take decisions in order to maximize shareholders wealth (Ding, Sun 2001). Even conflicts between family owners and family and non-family members within the family firms can be effectively solved by giving incentive SOPs (Catuogno, et al. 2018). Furthermore, shared capitalist compensation combined with good governance policies will make the employees have greater participation in decision making than those in non-ESOP firms. The adoption of share-based compensation in Indonesia itself is not really common. There are only 28 firms issued share-based compensation as reported in Indonesia Stock Exchange (IDX) in between 1999 to 2018 periods, but some firms actually adopt ESOP without reporting it in the IDX. The adoption of ESOP in publicly listed firms in Indonesia diversifies the quality of corporate governance implementation among the periods before and after the adoption (Setyaningrum, 2012). Despite of the numerous positive effects however, Stock Ownership Plan (SOPs) are a common tool for rent extraction, particularly when their wealth is already tied to the value of the firm in family-owned firm (Basu, Hwang, Mitsudome, & Weintrop, 2007; Morck & Yeung, 2003) and rent extraction is the most suitable explanation when SOPs is distributed to family knowing that their interests are already aligned with shareholders, compare to optimal contraction theory (Tiscini & Raoli, 2013). At certain level of family ownership, classical agency theory suggests in family-led firms that the closer interests between owners and managers, the higher the probability of using SOPs as rent extraction tool and when the interests are divergent, ESOPs provide alignment tool (Catuogno et al., 2018). The author suggests that higher number of independent directors on audit committee might lower the intention to expropriate minority shareholder. The independency of directors and committees is one of the good corporate governance determinants. Corporate governance is assessed through ratings that differs the company from good and bad governance. Good corporate governance is often found in large firms with high-investment opportunities, high-external financing needs, and high intangible assets (Khancel, 2008). On investors point of view, the ratings are believed to help them know the interest of company shares to investors. As for the company itself can reflect to the ratings before taking any decisions. Thus, this study has the objective to analyse the influence of corporate governance in family and non-family firms to grant ESOPs. The research is limited to non-financial family and non-family firms that is listed in IDX from 2013-2018.

### LITERATURE REVIEW

#### Family firms and corporate governance

Family ownership can also be determined as the form of concentrated ownership in firms (Gillan, 2006). Furthermore, other papers such as Luan et al. (2017) concluded that dominant managerial control power in a firm is one of the family business principals, the other is to have a large proportion of firm's equity ownership. However, family leadership should align the

interests of family owners and family and non-family members thus there is no need to exert compensation tool as cost of monitoring managerial behaviors. The desire to maximize family wealth somehow contrary to shareholder value maximization. Family owners prone to take opportunistic actions, including the usage of compensation tool as rent extraction or even to reward themselves with higher salary and it is not aligned with shareholder value maximization (Catuogno et al., 2018). Catuogno et al. (2018) suggests that agency conflicts are not enough to prove the relationship between family ownership and the aim of granting incentives in family-led firms.

Furthermore, in the context of family business, Brenes, Madrigal, & Requena (2011) stated that, boards of directors have to be clear on share succession and evaluating its impacts on company strategy since it affects shareholders' expectations and requirements with business' successors in charge. The authors further argue that a desire to control will always remain in family-led firms thus affects its board composition objectivity towards corporate governance and in many cases taking precedence over company's own health.

### **Corporate Governance**

According to The Indonesian Institute of Corporate Governance (IICG), Good Corporate Governance (GCG) defined as a system and mechanism in a way that encourage and control companies in order to transform available resources owned by the company to generate added value ethically. CG is not about compliance but also conformance with great performance and commit to create value. A good governance should give the right incentive to the management including board members to achieve firm's goals on behalf of stakeholders and shareholders interest and facilitate effective monitoring. To achieve effective monitoring, IDX amended rule No. I-A 2004 on the listing of Equity Securities Other Than Shares Issued by Listed Companies covers board monitoring such as a company board must have:

1. At least 30% of a listed company's board of commissioners is required to be comprised of independent commissioners.
2. At least one member of the board of directors of a listed company must be an independent director.

Gillan et al. (2003) findings suggests that large number of independent directors sitting in board combined with frequent board meetings will provide the most effective monitoring. Catuogno et al. (2018) also stated that board monitoring is one of the key components in solving agency problem, moreover, an effective board monitoring action, they found, would moderate the relationship between family ownership and increasing the likelihood of using ESOPs as an incentive tool rather than a rent extraction one.

### **Family firms and share-based payments**

Earlier study regarding incentives adoption in company, Zattoni (2007) states that stock ownership plan and stock option plan are compensation tools to minimize agency cost. The paper further explain that agency cost or agency problem is the cost resulting from misalignment of interest between principals (managers) and agents (employees). When both parties are utility maximizer, agents may have goals that are not aligned with principals' job and best interest.

In order to minimize agency cost and mitigate possible agency problem, monitoring on managers activities is necessary. However, according to Ding & Sun (2001) monitoring itself is expensive and never complete. Therefore, ESOP/SOP, as an incentive, appear to reduce monitoring cost as well as agency cost itself. Employee ownership does not only increase agents' motivation, but also align agents' interests with those of the principals (Wagner, Parker, & Christiansen, 2003). Several researches have stated ESOP as employee incentives that is proven to be effectively increasing firm's performance (Fang, Nofsinger, & Quan, 2015). However, ESOP also become an anti-takeover device for several large firms. Previous research by Dhillon and Ramirez (1994) resulted in a lower percentage of takeover activity with firms adopting ESOPs. Tax savings in adoption of ESOP/SOPs are also the reason why the incentives attractive to firms. Share-based compensation not only advantage the firm side, it is also providing tax and financial advantages.

In family firms, family will hold large stocks to consolidate its ownership of the company, and force the firm to act towards their interest. But this event will lead to a stronger agency conflicts because of shareholders' own demanding goal and interest. Even so, when the CEO is assigned from the family members, it reduces the agency cost because CEO can control firm's action to align with their own interests (Anderson & Reeb, 2003). As the concentration of ownership higher, so does the chance of aim alteration of ESOPs in the firms to rent extraction. Ownership concentration is defined as the percentage of shares held by the largest shareholder of the company (Lozano, Martinez, Pindado, 2016). However, higher concentrated ownership may lead to consequences, as Catuogno, et al., (2018) findings stated that family firms with low level of ownership are more likely to adopt ESOPs as incentive purposes, rather than rent extraction. They found the opposite occurs in family firms with high level of ownership, where the incentive purpose has diminished and generates rent extraction. Rent extraction is defined as non-value maximizing activities decision makers, or also called as managers of the firm, at the expense of shareholders, or also called as firm's owner, including aggressive financial reporting, extra consumptions, and related-party transactions.

### **The role of corporate governance in family firms with share-based payments**

Board monitoring plays role to help achieve Good Corporate Governance (GCG) according to the company's own principal (Catuogno et al., 2018). As Brenes, Madrigal, and Raquena (2011) says in their paper, having a formal board of directors is considered crucial to improve company performance and brings ease into the family. In Lozano, Martinez, and Pindado (2016), they saw ownership concentration as possible internal mechanisms of corporate governance as agency conflict mitigation between owners and managers. On the other hand, concentrated ownership may let agency conflict between majority and minority shareholders when majority of shareholders started to seek for private benefits (rent extraction). Thus, through their research, they conclude ownership as a convenient way to build a good corporate governance. Firms with independent board, besides financially sophisticated, is helpful to mitigate agency problem related to extreme tax aggressiveness which is highly associated with rent extraction. Desai & Dharmapala (2006) assume firms with poor corporate governance will less likely to adopt equity incentives to encourage tax avoidance driven by less governance mechanism applied to prevent rent extraction.

Based on literature above, the hypothesis for this research is there will be a linear relationship between corporate governance in family firms and the issuance of ESOPs. The stronger the governance will encourage family firms to issue more ESOPs.

## **METHODOLOGY**

In this research, all the companies listed on Indonesian Stock Exchange (IDX) during the 2013-2018 period are considered. The sample size is determined using purposive sampling method with certain criteria: Non-financial institutions listed in IDX that adopt ESOP during 2013-2018 with complete financial and annual reports. Furthermore, from the result of above criteria, family firms' sample are obtained through: Firms with affiliation relationship within its top management team including Board of Commissioners and Board of Directors and aforementioned firms that adopt ESOP during 2013-2018.

Considering family firms in Indonesia tends to have lower level of family ownership and by adapting Catuogno et al., (2018) classification of family firms, it must fulfill one condition: at least one family member involved in the top management team, board of commissioners and board of directors. To determine the family relationship in the company, in line with Catuogno et al. (2018), the similarity of family surname for each shareholders and board members are checked carefully through ownership and board structure provided in OJK websites and affiliation relationship reported in company's annual report. During the observation period, a total of 20 firms were identified, consists of 5 family firms with ESOP, 5 family firms without ESOP, 5 matched firms with ESOP, and 5 matched firms without ESOP. Matched firms are identified through listing year, industry, and size from the total sample in this research.

### **Dependent Variables**

ESOP in family firms are the dependent variables for this research. To help identify aim of share-based compensation adopted, it is analyzed towards ESOP characteristics. The fundamental characteristics of share-based compensation are considered, such as the strike price and the vesting period as prior studies suggested, Catuogno et al. (2018). If the ESOP strike price is at/out-of-the-money, it is considered influencing the aim of ESOP issuance to achieve economic benefits for shareholders (Zattoni, 2007). In this research, strike price is equal to one if the strike price in/out-of-the-money and zero otherwise. Additional characteristic, number of shares granted to total shares are also included in the research model.

Vesting period is necessary because it stimulates the top management of the firm to maximize economic benefits from decisions made and the longer the period, the higher the chance of top management to act and make economic decisions in line with value-maximizing goals (Catuogno et al., 2018).

### **Independent Variables**

Board monitoring, as proxied by the existence of independent commissioners and directors on board and frequency of board meetings, to further analyse the influence of quality of governance in the firm towards company motives to issue share-based compensation to its management and/or employees.

Family President Director, to prove the hypotheses regarding family involvement in the firm to influence aim of share-based compensation, value equal to one if the member of the family is holding the President Director position in the company and zero otherwise.

The additional independent variables, relating to corporate governance structure are the size of board, number of directors sitting on board (Arena et al., 2016; Catuogno et al., 2018). To assess the firm's characteristics, we included the size of the firm (SIZE), leverage of the firm (LEV), and how long the firm has been in business since its foundation (AGE).

All variables in this research is analysed with logistic regression method of panel data with random effect model using Stata 15.1 statistical software because the research model exhibits data in the same cross-sectional unit and observed over time. In addition, we use robust option in Stata to control for heteroscedasticity (Woolridge, 2013). Thus, we construct a model as follows:

$$Y_{it} = \alpha + \beta_1 X1_{it} + \beta_2 X2_{it} + \beta_3 X3_{it} + \beta_4 X4_{it} + \beta_5 X5_{it} + \beta_6 X6_{it} + \beta_7 X7_{it} + \beta_8 X8_{it} + \beta_9 X9_{it} + \epsilon$$

Dummy variable of the company granting ESOPs or not,  $i$ : Cross-section unit,  $t$ : Time,  $\alpha$ : Constant,  $\beta_1 - \beta_9$ : Coefficient Regressions, X1: Family ownership, X2: Family president director, X3: Independent director, X4: Independent commissioner, X5: Board meetings, X6: Board size, X7: Firm size, X8: Firm age, X9: Firm leverage,  $\epsilon$ : error

$Y_{it} = \alpha + \beta_1 X1_{it} + \beta_2 X2_{it} + \beta_3 X3_{it} + \beta_4 X4_{it} + \beta_5 X5_{it} + \beta_6 X6_{it} + \beta_7 X7_{it} + \beta_8 X8_{it} + \beta_9 X9_{it} + \epsilon$

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## FINDINGS AND ARGUMENT

**Table 1. Descriptive statistics**

Variable	Mean	Std. Dev.	Min	Max
GRANT	.2	.4016772	0	1
ESOP_GRANTED	.0022357	.0054029	0	.0284635
VESTING	3.266667	8.247977	0	60
STRIKE	.25	.5384385	0	2
INDEP_DIR	.1418915	.1092557	0	.4
INDEP_COM	.3970602	.0908551	.25	.6666667
BOARD	.7579652	.1333437	.4771213	1
MEETINGS	21.56667	14.64638	4	59
SIZE	30.14076	1.215945	26.93317	32.95985
AGE	3.645577	.5699273	2.197225	5.087596
LEV	.4991448	.221521	.000388	.9367596
FAM_OWN_DUMMY	.475	.5014684	0	1
FAM_OWN	.0303711	.0740286	0	.3451
FAM_PRESDIR	.3583333	.4815213	0	1

In this research, the level of family ownership proxied by percentage of ownership (*FAM\_OWN*) has a positive significant effect towards the issuance of ESOPs. Thus, higher and more concentrated ownership in a firm does influence the firm to grant ESOPs to their managers. In line with Catuogno et al., (2018), their findings suggest higher level of family ownership prone to pursue non-economic goals that are not in best interest of non-family members in the firm. Thus, agency conflicts are higher and incentive ESOPs are best implemented in such environment. Furthermore, a relationship between family firms and granting ESOP could be better described with using percentage of family ownership as independent variable in family firms' model. Using family ownership as family firms' identification, the results reject Hypothesis 1 because in listed firms' environment, family firms that are proxied by family ownership are not tend to issue ESOP. The frequency of board directors' meetings and the composition of independent commissioners that are significant to the likelihood of family firms on granting ESOPs while the composition of independent directors has no significant effect towards ESOPs issuance. The positive relationship between board meetings frequency and issuance of ESOPs is in contrast with a study of board meetings by (Vafeas, 1999). His findings suggest board meetings frequency is inversely related with the level of ownership held by executives and/or employees, which in our research is proxied by ESOPs. In addition, our findings recognize that the frequency of board meetings in all publicly listed firms in our sample, regardless family or not, are showing satisfying results by increasing the likelihood of firms to grant ESOPs.

## CONCLUSIONS

This paper aims to analyse the influence of corporate governance practices on granting incentive ESOPs through board monitoring in listed family and non-family firms' environment. Thus, using listed family and non-family firms in IDX that issued ESOP within 2013-2018 period, this study employed family characteristics (family ownership and family president director) and corporate governance practices (independent directors, independent commissioners, board of directors' meetings, and board size) as independent variables. Hence, the study provides additional factors affecting ESOPs issuance in both family and non-

family firms. In addition, a comparison of corporate governance practices in board monitoring between family and non-family firms is conducted.

After controlling for firm's characteristics (size, age, and leverage), the research found that in a family firms' environment, percentage of family ownership has a significant effect for family firms to grant ESOPs. This is in contrast to Sanjaya (2012) paper that argues firms with concentrated ownership and family members in the board will less likely to adopt ESOPs to resolve agency conflicts between managers and shareholders because their interests are already aligned. Meanwhile, in the context of corporate governance practices, only the composition of independent commissioners and board of directors' meetings frequency have a linear relationship to grant ESOP. These results occurred in family firms may be explained the governance structure of family ownership combined with non-family managers reduces agency conflict (Purkayastha et al., 2019).

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