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Alignment Hypothesis Versus Risk of Expropriation: Road to Sustainable Performance

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Abstract: Global economic crisis in present may have countless effects on the company performance. The key solution to this problem is to mitigate any problems and minimize any possible losses in this perplexing economy. Agency problems that still exist continue to become one of the biggest challenges for the companies to sustain high performance. Though some may try to align the conflicting interest, the possibility of entrenchment effects that lead to risk of expropriation could negatively affects performance of the company. This study is emphasized on the needs of interdisciplinary studies to obtain sustainable performance. Suggested conceptual framework is presented to represent the relationship between agency problem, entrenchment effects and sustainability issues and subsequently proposed possible solution. Following the Theory of Reasoned Action (TRA), it is suggested that good managerial process complement by an effective organization control may be able to reduce negative effects and subsequently sustain company performance to its long term success. Effective performance management system must be well understood and implemented to ensure that the mechanisms work effectively.

Key words: Alignment hypothesis, entrenchment effects, managerial process, performance management systems, Malaysia

INTRODUCTION

The world economy stumbled in 2015, amid weak aggregate demand, falling commodity prices and increasing financial market volatility in major economies. The widespread slowdown across emerging and developing economies is a source of concern for the global economy and poses a threat to the sustainability of a company. The pressures in the boardroom transcend downward to all levels of the company, as profits and financials reserves continue to decline. Emphasized is made on the importance of great leadership to skull the business (Ranganayakulu, 2005). Under pressure to extend the firm's profitability and also maintaining power in the firm, management tend to act unethically such as involve in 'creative accounting' practices. Top managers that motivated to achieve their own personnel interest at the expense of others (be it the shareholders/owners of the company) might put the company at risk. If the issues are unresolved, company may have difficulties to sustain their financial and non-financial performance.

Connection between ownership structure, management structure and performance of the company has been subjected to ongoing debate in the corporate finance literature. Issues related to the separation of ownership and company performance can be well explained by using agency theory. Jensen (1986) agency theory demonstrates that owners-managers interest may diverged from owners non-manager interest. Manager and costs and conflicts may exist due variations of conflicted interest and information asymmetry between the owners and managers (Charbel *et al*., 2013). These actions may bring forward to agency cost that can hurt shareholder value or the performance of the company (Castro and Aguilera, 2014).

Given the current issues, numerous solutions are proposed by previous literatures to reduce the problems. This includes alignment theory whereas the managers' interest is aligned to the interest of the owners. This is apparent especially if there is family involvement in business which may lead to convergence of interest that can reduce agency costs of the firm (Claessens *et al*., 2000). Accordingly, family managers will act as steward that consider the success of the company as their own rather than act as an agent seeking of to achieve personal benefits at the expense of the company (Charbel *et al*., 2013). Despite these, attention must be paid on the possibility of entrenchment effects occurred in a family ownership or concentrated ownership where the managers are also shareholders of the firms.

Conflicting views on these causes and effects may affect performance of the company negatively. If the

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situations persist, company might have difficulties to sustain performance in the future. The long term success is no longer possible to be achieved and sustained especially in this challenging economy. Therefore, the study aims to conceptualize the importance of mitigate agency problems and entrenchment effects in order to ensure the performance of the company can be sustained in the future years. To achieve this, it is suggested that some element of management accounting (managerial process) may have some effects to the problems.

MATERIALS AND METHODS

Focused issue

Agency problem: Issues on agency problems has been well discussed since the early of 1990 with emphasized on various aspects inclusive indicators of agency costs (Cohen and Uliana, 1990) types of agency costs involved (Hall, 1998) ways to mitigate the issues (Hall, 1998) and the impact of agency problems to the performance of the company (Jensen, 1986; Kim and Lee, 2003; Charbel *et al*., 2013). Example of conflicts incurred that can give rise to excessive conflicts with shareholders' interests include excessive levels of management remuneration, neglect of management duty, focus on short term performance rather than profitability long term venture that can detriment the value of shareholders, empire building by managers and employee welfare objective (Cohen and Uliana, 1990). Agency problems that are not well managed effectively may deteriorate company performance.

To determine whether agency costs are reduced, many studies have been conducted to measure the relationship between ownership and performance. Focused are made to see whether institutional ownership that monitor and control activities or family involvement business be able to reduce agency costs. For instance, it is found that family involvement in ownership and management has positive relationship with the financial performance of the companies (Charbel *et al*., 2013). This is supported by a recent study whereby family firms are more profitable than companies that are widely held or non-family blockholder (Isakov and Weiskopf, 2014).

Alignment hypothesis versus entrenchment effects: To moderate the agency costs, companies can align manager's interest with shareholders through few mechanisms which include link remuneration of managers to the market value of the company's share price (Brighma, 1993) and this can be done by offering share option scheme to the managers (Hall, 1998). Other proposed solutions include strengthened the companies' corporate government, make known of shareholders control, shareholders interference and threat of dismissal or takeover (Chang *et al*., 2016). In fact, Fama and Jensen (1983) argue that agency costs can be reduced in other setting where relationship exists among owners and managers.

However, entrenchment could occur at the expense of minority shareholders especially in a setting where managers who are also the owners have occupied core position for a significant time (Charbel *et al*., 2013). Besides, managers with high level of control or high voting power can be associated with strong, negative entrenchment effects or larger agency problems and firms with these board structures are valued less by investors (Yeh and Woidtke, 2005). Despite the alignment incentive given, at certain level these managers could still make decision for their own personnel interest. Given these, agency costs will be reborn between agents and principal (Charbel *et al*., 2013) and conflict of interest could arise between controlling owners-managers and minority shareholders non-managers. Entrenchment prospective suggested that the controlling shareholders may abuse power for their own benefit and therefore this opportunistic behavior would deter outside investment and negatively affects firm value (Chahine, 2007).

Company sustainability: There is a conflicting view on the alignment hypothesis where as it can alleviate agency costs but can still decrease value of the firm (Villalonga and Amit, 2006). Similarly, there are conflicting views and evidence regarding the nature of the relationship (Cheung, 2010) where some might reported positive, negative, neutral (Castro and Agailera, 2014) and even non-linear relationship which indicate of possible presence both the convergence-of-interest and entrenchment effect (Davies *et al*., 2005; Shleifer and Vishny, 1997; Saad and Haniffa, 2014; Chen and Yu, 2012).

Accordingly, alleviating agency costs is not enough to achieve sustainable performance. Failure of the leader to have an accurate understanding of the marketplace in which the organization must compete would also result in the major deterrence of company sustainability (Owen *et al*., 2001). Essential management practiced is important to help company to be great and to achieve evergreen business process (Gronholdt and Martensen, 2009). Undeniably, company must be able to devise and maintain a clearly stated, focused strategy, develop and maintain flawless operational execution, hold on to talented employees, make industry-transforming innovations and find leaders who are committed to the business and its people (Gronholdt and Martensen, 2009). Leaders need to be better equipped and motivated towards achieving a workable balance between short term and the longer term future activities (Owen *et al*., 2001).

RESULTS AND DISCUSSION

At present issues on agency cost, concept of alignment hypothesis to mitigate the agency costs and the possibility of entrenchment effects has been widely discussed in corporate finance literature. However, little has been discussed on the effect towards sustainability performance if the issues continue to persist. The fact that agency cost can be reduced but difficult to eliminate and due to the possibility of risk of expropriation or entrenchment effect may prevent company in achieving sustainable performance. Therefore, it is suggested that some element of management accounting can be introduced in the framework in order to sustain performance of the company. Interdisciplinary studies might able to provide better explanation on how the elements can affect performance of the company. Figure 1 represent suggested conceptual framework of the studies which consists of three elements. First element includes the issues that have been widely discussed in corporate finance area. Second element comprise of additional new area that can be included to provide better solutions and control. Finally, it is hoped that it would result in better expected outcomes of which to achieve sustainable performance. Academicians and practitioners need to understand that each of the elements is interrelated to each other. Theory of Reasoned Action (TRA) is one of the most popular theories that can explain the variability of behavior in various environments (Saad and Haniffa, 2014).The most important determinant for a particular behavior is intention; a form of motivation that can drive the behavior of a person (Saad and Haniffa, 2014). The stronger motivation exist to achieve certain target will influence, the higher the probability of action will be taken to achieve the intended outcome. Performance management practices and employees attitudes are crucial to manage the performance of the companies (Kagaari *et al*., 2010). Performance management designed must be able to align the interest of managers and shareholders. Managers will then be motived to act in a way that benefits the company as a whole.

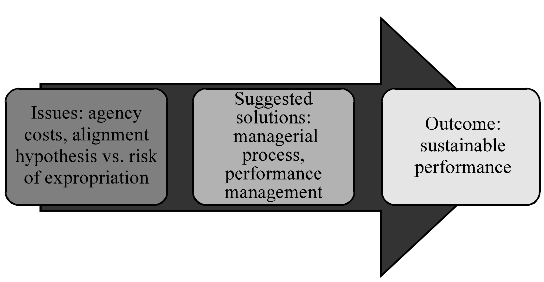

Fig. 1: Suggested conceptual framework

Traditionally accounting based performance measures tools could be categorized as being financially based, internally focused and backward looking (Cohen and Uliana, 1990). The difficulties to help managers focused on their critical area can be reduced through the introduction of balanced scorecards that take into account of multiple perspectives that important to the business. Ways to achieve the strategy of the firm is being communicated to the companies through various perspectives covered by the balance scorecard (Seraphim, 2006). Strategic planning of the companies includes the vision; mission and objectives were communicated to all employees through the agreed balance scorecard. These are intended based on the saying that what the company is measuring will be the outcome that companies will achieve (Kaplan and Norton, 1992). Performance management designed such as the balance scorecard perspectives need to represent the interest of the shareholders in order to reduce the agency cost. Accordingly, if the managers are well being compensated and being control by ways of good performance management systems most probably managers will behave align with the interest of shareholders and support the sustainable development of the company.

Noted that, whilst operational and support processes deliver performance presently, it is the managerial processes that sustain performance over time (Bititchi *et al*., 2011). Managerial process is concerned with sustaining and enhancing company performance in the future by looking at various factors which include setting direction of the company, manage strategy, build organizational competent, manage performance and manage changes (Bititchi *et al*., 2011). They found that the execution of the managerial process and systems is influenced by the perceptions of the managers who organized it. Employee and customer attitudes are grounded in current organizational culture and practices which is a prerequisite to improve organization's capacity to sustain high performance (Owen *et al*., 2001). Company is comprised of individuals with diverse of conflicting objectives.

To elaborate further the suggested conceptual framework, researchers will explain via the simple example provided. For instance, company A is an established company listed in the main board of Bursa Malaysia Stock Exchange. There is a separation between ownership and managers of the company. Due to the global economic crisis, managers who run the company might act according to their personnel interest at the expense of the owners. Worst, performance of the company deteriorated. To solve the issues sometimes managers are being offered the stocks to align the conflicting interest. However, as managers hold more shares in the companies' entrenchment effect could appear as managers now would have greater voting powers and control towards the direction of the company. It can be seen from the example here that alignment hypothesis cannot solve the issues due to the possibility of entrenchment effect or risk of expropriation. However, if systematic managerial process is present, there is a possibility that good performance management system can be designed that will align the interest managers and the shareholders and subsequently contributed to its long term positive performance.

In short we would like to suggest that given the well-known agency problems that can be reduced but difficult to be eliminated; proper managerial process must be implemented. Managerial process is concerned with sustaining and enhancing performance in the future and it can include activities such as setting the direction, manage strategy, build organizational competence and manage change (Bititci *et al*., 2011). Strategic managerial process supported by good managerial process would enable the issues to be solved and subsequently achieve high performance.

CONCLUSION

This study contributes to interdisciplinary studies specifically corporate finance and management accounting field, in particular the relationship between agency problem, entrenchment effect, managerial process and sustainable performance. Based on the discussion above, agency problems that has been continued to exist should not be taken lightly but need to be address to ensure the level of agency cost would not deteriorate the performance of the company. With proper understanding of managerial process and strategic implementation of performance management system, it is hoped that companies able to align the interest between managers and shareholders and subsequently reduce the agency problems to sustain the performance of the company.

Although, this conceptual study provides some attention towards the needs of interdisciplinary studies, the discussion brought forward must be construed with consideration. Therefore, it is suggested that future studies need to be conducted to have more comprehensive view on the needs to integrated management accounting practices in corporate finance literatures.

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