Agency Relationship in Multinational Corporation (Headquarter to Subsidiaries Firm): Collectivism Culture of Indonesia

S. Martono[1], Pan, Wei-Hwa[2], Arief Yulianto[1,*] and Angga Pandu Wijaya[1]

[1]*Department of Management, Faculty of Economics, Universitas Negeri Semarang, Indonesia.*

[2]*Department of Business Administration, National Yunlin University of Science and Technology, Taiwan.*

Abstract: The research aims to understand the differences in agency costs of multinational corporations (MNCs) caused by cultural variations between the headquarters in emerging countries and subsidiaries in developed countries. The data was collected from mining and energy sector companies listed on the Indonesia Stock Exchange from 2007 to 2022. The t-test was used to analyze 647 observation units, with 370 being domestic firms and 277 being MNCs. The findings reveal that MNCs have higher total assets and annual sales compared to domestic corporations. However, there was no significant difference in agency costs between them, as both were able to deploy assets for only 50 percent of total sales. Managers of MNCs in developed countries feel superior, and the shift from collectivism to individualism in the national culture for domestic firms has resulted in subsidiaries being reluctant to adopt management practices.

Keywords: Agency Cost, Asymmetric Information, Culture of Multinational Corporation

INTRODUCTION

Relationships between headquarters (HQ, hereafter) and subsidiaries in multinational corporations (MNCs) potentially generate more agency conflicts compared to domestic firms (Ambos et al., 2019; Kostova et al., 2016). The geographical differences between them suggest that subsidiaries may act differently for the best interests of HQ and the corporate group (Kostova et al., 2018). Chang et al., (2009)show research has mainly focused on MNCs with HQ in developed countries, while MNCs in developed and newly industrialized economies have been reported for a long time. We extend the study to MNCs with HQ in emerging countries and subsidiaries in developed countries. Indonesia is an emerging country with abundant natural resources (coal, copper, gold, tin, and nickel). The majority of the HQ of the MNCs are located in Indonesia, and the subsidiary corporations, which are supporting businesses (investment, processing, shipping, marketing), are located in developed countries.

The agency theory perspective enhances our understanding of the HQ-subsidiaries relationship, where agency costs (residual loss) may arise due to the difficulty of monitoring subsidiaries in different countries by the HQ (Jensen, 1986; Jensen & Meckling, 1976). Subsidiaries possess more local demand and information knowledge than the HQ, making them potentially opportunistic and not always acting in the best interest of the HQ. Residual loss is exacerbated when the managers of subsidiaries in developed countries feel superior to the HQ managers in emerging economic countries, leading to a lack of interest in adopting practices implemented by HQ managers.

The perspective of the agency theory of MNCs recognizes that agency relationships do not occur in a vacuum but take place in a social context, such as cultural control, which motivated this research. When national culture transforms into cultural differences between the HQ and subsidiaries operating in different countries, there will be cultural discrepancies between them (Hofstede, 1980; Hofstede & Bond, 1984). Hofstede (1980) study of 40 subsidiaries within one HQ suggests that people within a nation share a collective mental program. They interpret experiences in a certain way, which differs from the interpretations of other cultures. This mental program develops during childhood and, due to reinforcement and institutionalization in legal systems, government, schools, and organizations, changes in culture do not happen rapidly. As a result, the organizational culture in subsidiaries may differ from the HQ, leading to more agency costs.

Conversely, when the dominant culture of the HQ serves as a mechanism to control deviant behavior from subsidiaries, managers in the HQ or corporate group have the capability to transmit and transform values and norms to subsidiaries in different countries, resulting in fewer agency costs (Groot & Merchant, 2000; Jaeger & Baliga, 1985). Our paper aims to determine whether there are differences in agency costs between HQ of mining and energy sector companies in Indonesia and subsidiaries in different countries.

The paper is organized into the literature review in the second section, the research method in the third section, and the results and discussion in the fourth section, followed by the conclusion in the fifth section.

*Address correspondence to this author at the Department of Management, Faculty of Economics and Business, Universitas Negeri Semarang, Indonesia; E-mail: martono@mail.unnes.ac.id

LITERATURE REVIEW

Development of MNCs in the Mining and Energy Sectors in Indonesia

Heryanto (2003) documented the development of MNCs in three stages. The first stage was from 1965 to 1974, during which the Indonesian government encouraged foreign investment. The perspective of imperfect market theory, Madura (2008) initiated the establishment of subsidiary firms in Indonesia with headquarters in different countries. The second stage was from 1974 to 1990, characterized by a focus on economic growth and reliance on multinational or MNC companies. In 1974, the government introduced a series of capital investment policies, which included requirements for all foreign investments to be in joint ventures, with the majority of shares designated for domestic participants within 10 years, and prioritization of the use of local labor. The third period, from 1990 to the present, saw the introduction of new economic laws and policies, leading to a more transparent and accountable economic environment. As a result, economic growth became more stable, and foreign direct investment (FDI) increased. The mining industry in Indonesia has ample room for development and is proud to possess one of the world's largest mineral reserves, rich in natural resources such as coal, copper, gold, tin, and nickel. The mining industry employs millions of people, contributing around 11% to Indonesia's GDP and making a significant contribution to the country's economy (Suryantoro & Manaf, 2002).

The 2020 Mining Law aimed to simplify mining regulations in Indonesia, a significant producer, to boost domestic economic growth. Despite concerns about infrastructure needs, environmental sustainability, and social responsibility, Minister of Trade Regulation number 8 of 2023 on export procedures has been issued. As a result, major producers or HQs in Indonesia have incentives to have subsidiaries in different countries to support the HQ's business. The coal sector is the largest contributor to the mining industry in Indonesia, with the majority of coal production located in Kalimantan and Sumatera. Coal is primarily used for power generation, and Indonesia is one of the world's largest coal exporters, with around 46% of total coal production being exported. Nickel is another major product, with the majority of production located in Sulawesi and Halmahera in Indonesia. Nickel is a key component in stainless steel production, and global demand for nickel is expected to increase as countries focus on infrastructure and renewable energy development. The mining industry in Indonesia also benefits significantly from copper and gold production. Indonesia is the second-largest copper producer in the world, with Papua being the largest copper-producing region. West Java, North Sumatra, and Papua are the main gold-producing areas; Indonesia is the 14th largest gold producer globally.

Agency Theory of MNC: Cultural Setting

Asymmetric information has initiated agency conflicts between principles (HQ) and agents (subsidiaries) (Akerlof, 1970; Eisenhardt, 1989; Jensen & Meckling, 1976). HQ acts as the principles and has subsidiaries in different countries, which leads to their efforts to ensure coordinated and cooperative actions by subsidiaries in resource allocation to enhance the overall value of the multinational corporation (MNC). However, the differences in operational regions have resulted in monitoring difficulties by HQ (principles) over subsidiaries (agents). Subsidiaries possess more information about local demand and operational aspects compared to HQ, leading to increased agency costs for HQ.

We argue that the differences in cultural settings cannot assume that subsidiaries are perfect agents but may allow for variations. Agency theory is based on the rational self-interest of principles and agents, with agents being utility maximizers and acting in their own interests. The Hofstede Centre (2015)explains that Indonesia is a country with a low collectivism score (14), indicating a strong cultural preference for a social framework in which individuals are expected to conform to the aspirations of their community and group. This cultural alignment between individuals and the country can reduce agency costs (Matsumoto et al., 1998). However, in the case of domestic companies, the HQ and subsidiaries are located in the same country, making the adoption of management practices from HQ to subsidiaries less likely.

From the agency theory perspective, when the behavior of agents or managers of subsidiaries is primarily influenced by national culture, HQ will engage in more monitoring, leading to increased agency costs. Culture significantly influences the feasibility and willingness to transfer management practices from one country to another (Hofstede, 1980). Moreover, the greater the cultural distance between HQ and subsidiaries, the less likely the subsidiaries are to affiliate and adopt management practices from HQ. Furthermore, when subsidiaries are located in developed countries and the presence of culture leads to managers feeling more competent than HQ managers, the transfer of values and norms from HQ to subsidiaries is less likely to occur. Therefore, the research hypothesis is that cultural differences result in higher agency costs for HQ in multinational corporations compared to domestic firms.

RESEARCH METHODS

The implementation of Circular Letter from Indonesia Stock Exchange Number: SE-00003/BEI/01-2021 resulted in changes in the sector classification from mining (subsectors including coal mining, crude petroleum and natural gas production, land/stone quarrying, and metal and mineral mining) to energy (sub-sectors including oil, gas, coal, and alternative energy). Data from companies for the period 2007 to 2022 were collected, with 370 being domestic firms and 277 being multinational corporations (MNCs), making a total of 647 observation units.

The proxy for agency cost adopted the model of Ang et al., (2000), which measures agency cost using the Asset Utilization Ratio (total sales scaled by total assets). This ratio aims to assess how effectively a firm's management deploys its assets. If the deploy assets ratio is lower than 1, it indicates opportunistic behavior by subsidiaries. This behavior can involve purchasing unproductive assets, leading to lower revenues and poor investment decisions, resulting in the underutilization of total assets. Such behavior indicates that subsidiaries do not act in the best interest of the HQ. The t-

Table 1. Data Analysis.

	Types			
	Domestic	**MNC**	**All Firm**	**Mean Diff**
Panel A: Total Assets (Billion Rupiahs)				
N-Obs	370	277	647	
Mean	7,818.5	16,914.8	11,712.9	9,096.3*
Std Deviation	16,152.2	22,577.4	19,674.8	
Kurtosis	19.4	7.6		
Skewness	4.1	2.6		
Panel B: Annual Sales (Billion Rupiahs)				
N-Obs	370	277	647	
Mean	3,243.4	7,266.8	4,965.9	4,023.4*
Std Deviation	6,595.4	10,159.7	8,539.1	
Kurtosis	11.5	17.9		
Skewness	3.2	3.4		
Panel C: AUR (Asset Utilization Ratio)				
N-Obs	370	277	647	
Mean	0.50	0.51	0.51	-0.01
Std Deviation	0.67	0.38	0.56	
Kurtosis	119.87	1.80		
Skewness	8.73	1.15		

test was used for data analysis to determine the differences in agency costs between MNCs and non-MNCs in the cultural setting of collectivism in Indonesia.

RESULTS AND DISCUSSION

The agency cost data were displayed for the 647 samples, divided into two groups: domestic firms and MNCs. Table 1, Panel A, shows the significant mean differences between the two groups. MNCs have a mean total asset value that exceeds domestic firms (9,096.3 billion rupiahs). The kurtosis of MNCs (7.6) is less than that of domestic firms (19.4), indicating that the total assets of MNCs are more homogenous than domestic firms. For both MNCs and domestic firms, the majority of total assets are below the median, as indicated by the skewness.

Table **1**, Panel B, displays that MNCs have a mean total sales value that exceeds domestic firms, and the difference is statistically significant (4,023.4 billion rupiahs). The total sales of domestic firms are more homogenous than those of MNCs, and both exhibit negative skewness.

The larger total assets and annual sales owned by MNCs compared to domestic firms can be attributed to the nature of the characteristic business vertical MNC groups in Indonesia. Each subsidiary within the MNC is assigned a specific task in the overall business chain. The HQ, situated in Indonesia, coordinates and oversees the activities of these subsidiaries, which are involved in diverse tasks such as investment, processing, and marketing in foreign countries.From the perspective of the imperfect market theory, ex ante, subsidiaries (principles) possess more information and knowledge about their specific operational regions than the HQ (agent). This information asymmetry between subsidiaries and the HQ leads to suboptimal monitoring of the subsidiaries by the HQ. The differences in geographical distance and cultural settings create challenges for effective monitoring and coordination, which can result in higher agency costs for both MNCs and domestic firms.

Analyzing the data in Table 1, Panel C, it becomes evident that the mean agency cost does not significantly differ between MNCs and domestic firms. Both types of firms face challenges in optimally deploying their assets to generate revenue. The fact that only around 50 percent of the assets contribute to total sales indicates a potential for improvements in asset utilization and efficiency for both MNCs and domestic firms.While national culture plays a significant role in shaping managerial behavior and decision-making, it does not guarantee the prevention of agency problems. The paper's findings suggest that the presence of national culture, whether in MNCs with HQ in Indonesia and subsidiaries in developed countries or domestic firms with HQ and subsidiaries in Indonesia, does not fully address the issue of agency costs.

The possible explanation for this is that managers of subsidiaries located in developed countries may perceive themselves as more competent and experienced than their counterparts in the HQ, leading to resistance in adopting values and practices from the HQ. Additionally, the diverse cultural backgrounds within Indonesia may result in subsidiaries' managers being reluctant to adopt practices from the HQ, even when they come from the same ethnic background. These factors contribute to the challenges in achieving effective coordination and alignment of interests between principles and agents in both MNCs and domestic firms.

The research highlights the complexity of agency relationships within MNCs and domestic firms and the significant influence of cultural factors on managerial behavior. While the larger total assets and annual sales of MNCs compared to domestic firms may suggest a higher level of financial resources, it does not necessarily translate to more effective management and lower agency costs. Addressing agency problems requires a deeper understanding of cultural dynamics and effective strategies for communication, coordination, and alignment of interests between HQ and subsidiaries.

Several studies have highlighted the impact of cultural differences on agency conflicts between principles (HQ) and agents (subsidiaries). The relevant study by Chang et al. (2009) emphasized the importance of cultural control as a mechanism to influence behavior within organizations. It argued that when HQ managers actively engage in promoting and socializing values and norms aligned with the HQ, it can help ensure that members of the organization accept and adhere to these values and norms. This cultural control mechanism is informal in nature and relies on influencing individuals' behaviors and decision-making through shared values and norms.Similarly, the research by Groot and Merchant (2000) highlighted the significance of cultural alignment between HQ and subsidiaries in multinational corporations. It emphasized that when there is a strong cultural fit, the transmission and transformation of values and norms from the HQ to subsidiaries become more effective, which can lead to better control over agency problems.

However, contrary to the expectations drawn from previous research, the findings in this paper suggest that the presence of national culture does not fully address the agency problems within both MNCs and domestic firms. Despite the cultural alignment within MNCs with HQ in Indonesia and subsidiaries in developed countries, and the shared national culture in domestic firms, agency costs remain relatively high. The reluctance of managers in subsidiaries, particularly those in developed countries, to adopt practices from the HQ in emerging countries indicates that the cultural control mechanisms may not be as effective as expected. The diverse cultural settings within Indonesia, influenced by more than 200 ethnic groups, have also contributed to the resistance of subsidiary managers to adopt practices from the HQ, even when they come from the same ethnic background. This highlights the complexity of cultural dynamics within the country and its impact on agency relationships.

The previous research findings, along with the results presented in this paper, suggest that the relationship between cultural settings and agency costs in multinational corporations and domestic firms is multi-faceted and not straightforward. While cultural alignment and control mechanisms may play a role in managing agency conflicts, other factors such as managerial perceptions, economic conditions, and the uniqueness of each business environment can also influence the outcomes.To address agency problems effectively, it is essential for organizations to consider not only cultural factors but also a holistic approach that encompasses communication, coordination, and alignment of interests between HQ and subsidiaries. Future research can delve deeper into understanding the specific cultural dimensions and management practices that influence agency costs in different contexts, providing valuable insights for MNCs and domestic firms seeking to improve their corporate governance and performance.

Previous research, as highlighted (Chang et al., 2009; Groot & Merchant, 2000), have emphasized the significance of cultural alignment and control mechanisms in addressing agency problems within multinational corporations. It has been believed that when HQ managers actively socialize and promote values and norms that align with the HQ, they can effectively influence the behavior of subsidiaries. The cultural control mechanism, an informal approach, is expected to shape the actions and decision-making of individuals within the organization.

However, contrary to these expectations, the findings from Jaeger & Baliga (1985) indicate that the transmission and transformation of HQ's beliefs and values to subsidiaries are not as successful as envisioned. Both in multinational corporations and domestic firms, the indoctrination of HQ's values fails to fully permeate the subsidiary level. This indicates that the cultural control mechanism may not always be as effective in bridging the gap between principles and agents within organizations.

In the context of Indonesia, the researchers argue that the national culture's values and norms have diminished, leading to a shift towards individualistic behavior rather than collectivism. This transformation in cultural dynamics may impact the willingness of subsidiary managers in domestic firms to adopt management practices from the HQ. Additionally, the diversity of cultural settings in Indonesia, influenced by over 200 ethnic groups, contributes to the variation in managerial behavior and decision-making within the subsidiaries.

Focusing on MNCs with HQ in Indonesia and subsidiaries in developed countries, the study highlights the potential influence of the better economic conditions and overconfidence of subsidiary managers in developed countries. These factors may lead them to reject management and business practices implemented by the HQ in emerging countries. Such resistance could contribute to agency conflicts and hinder the effective coordination and alignment of interests between the principles and agents.The combination of previous research and the findings from this paper suggests that cultural factors alone may not be sufficient to fully mitigate agency costs within multinational corporations and domestic firms. Other contextual elements, such as managerial perceptions, economic conditions, and the unique characteristics of each business environment, also play crucial roles in shaping agency relationships.To address agency problems effectively, organizations operating in diverse cultural settings like Indonesia need to adopt a comprehensive approach. This approach should encompass strategies for communication, coordination, and alignment of interests between the HQ and subsidiaries. Recognizing and respecting cultural differences while promoting shared values and norms can be a more effective way to manage agency conflicts and enhance overall organizational performance.

CONCLUSION

The presence of national culture replacing monitoring and bonding mechanisms in preventing agency costs has sparked considerable debate. However, at least this paper contributes to the ongoing improvement of agency cost research, where inconsistent results are still prevalent.The findings show that MNCs have more total assets and annual sales compared to domestic corporations, but both exhibit relatively high agency costs. They are only able to deploy total assets to generate around half of their annual sales. The presence of national culture, whether in MNCs with HQ in Indonesia and subsidiaries in developed countries or domestic firms with HQ and subsidiaries in Indonesia, is unable to prevent agency problems.Managers of subsidiaries located in developed countries feel superior and are reluctant to adopt the values, norms, and cultural management and business practices from HQ managers in emerging countries. Similarly, the national culture in Indonesia, formed from various ethnic cultures, has led to subsidiary managers' reluctance to adopt practices from HQ, even when they come from the same ethnic background.

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