

## **The Role of Family Control on Financial Performance of Family Business in Gebze**

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**ABSTRACT:** This paper analysis the role of family control on financial performance of family business by using the key financial data of family businesses of 16 firm registred to Gebze Chamber of Commerce. In this paper, financial performance of a family business is measured by using Return on Assets, Return on Sales and Total Debt/Total Assets ratios. The family member CEO is more successful as far as ROA ratios concerned, but is less successful as far as TD/TA ratios concerned, in comparison to non family member CEO. In other words, the non family member CEO is more successful as far as TD/TA ratios concerned, but is less successful as far as ROA ratios concerned, in comparison to family member CEO. Additionally, as far as ROS ratios concerned, there is no significant difference between family member CEO and non family member CEO. Overall, the results are consistent with the hypotheses that there is difference between ROA of family member CEO and non family member CEO, and there is difference between TD/TA of family member CEO and non family member CEO.

**Keywords:** Family business; Family control; Financial performance

**JEL Classifications:** G32; G34

### **1. Introduction**

In recent years, firm performance has received considerable attention as a substantial academic subject for investigating family business in the financial and management literature. Researchers and academicians have chosen different approaches for the exploration of this issue. In the previous studies, the effect of family ownership, family control, control-enhancing, family business versus nonfamily business and founders versus second following generations have analyzed on firm performance by financially and non-financially.

Family businesses' performance is better than nonfamily businnesses, for both profitability and financial structures; and on the other hand, the level of family control strongly influences performance, at least in terms of profitability (Allouche et al., 2008).

Family firms controlled by the founders are generally run more efficiently, and have greater value as measured by the market equity / book equity ratio than other firms have and also, carry less debt in comparison to other firms (McConaughy et al., 2001). Bhagat and Bolton (2008) mentioned that the stock ownership of board members and the board independence are positively correlated with poor firm performance.

Zahra (2003) shows that family involvement in management makes a significant difference in explaining its internationalization with higher sales in the international operations of family firms. Chrisman et al., (2004) found out that the short-term sales growth for small family and nonfamily firms are statistically equal.

Assuming all other things constant, family firms are better off in terms of faster growth and bigger profitability. Firms, in which founding family members participate in management, perform even better. Despite their stronger growth, no evidence is found that family firms are less stable than other firms in the long run (Lee, 2006).

Anderson and Reeb (2003) found that family firms with founding family ownership and a family CEO, significantly show better performance than nonfamily firms by using profitability-based measures of firm performance. However, family firms with founding family ownership and a founding family CEO or a nonfamily CEO combination accumulate higher market value creation.

The role of family control on financial performance is an empirical issue. It is investigated in this study and this paper is structured as follows: first, an introductory section, then, a literature review on family business, governance system, family control, firm performance related to financial ratios is analyzed. This is followed by hypotheses and creation of a model describing the effect of family member CEO and non family member CEO on firm financial performance. Later, a sample of 16 family-owned companies in Gebze is examined with respect to Return on Assets, Return on Sales and Total Debt / Total Assets from financial ratios to determine the effect of family member CEO and non family member CEO on financial performance of family business. The sampling and methodology are described, and the results of study are obtained, evaluated and explained. The last section includes the conclusion with leading the way for future researches. The frame of research question is to seek an answer to the question of that “does family control play a role on financial performance of the family business in Gebze?”

## **2. Literature Review**

### **2.1 Family Business**

Family businesses have significant role in the world economy. Studies show that three tenth of family businesses are transferred to the second generation, while the average life of a family business is 24 years which is significantly short.

There are different definitions of family business and no clear consensus has emerged concerning the definition of Family Business. Content, purpose and family influence are the common aspects of the family business definitions. Most definitions are focused on ownership, family involvement, family control and the intention to transfer the family firm, etc. Issues like ownership, governance and trans-generational are also included to the definition of family firm for analyses purposes. In brief, some definitions are still open to discussion, but the elements of involvement and the core approaches seems to be overlapping (Chrisman et al., 2005).

According to the Bowman-Upton' s (2009) simplified definition, a majority of the ownership or control are under a family, and two or more a majority of the ownership or control are under a family business which is like any business.

Churchill and Hatten (1987) who say the family owned business is a founder-operated business where there is the anticipation that a younger family member will assume control of the business from an elder member.

Between the various definitions, Chua et al. (1999) propose a definition in their research which is inclusive of all other definitions in the literature. According to this definition, the family business is a business governed and/or managed with the intention to shape and pursue the vision of the business that is shared by a dominant coalition controlled by members of the same family or a small number of families in a manner that is potentially sustainable across generations.

Another definition is focusing on components of family business, such as ownership, governance, management, and transgenerational succession; and the definition concerning on what is a family business, including the intent of the family to keep control, firm behavior, and idiosyncratic resources that arise from family involvement, are differentiated by Chrisman et al. (2005).

Astrachan et al. (2002) developed the Family Power Experience Culture Scale to measure family involvement in business and in the new definitions; the common points are family, management, ownership, and business but they include culture into the family business definitions. The culture should be included since family's specific culture becomes business culture in time.

Therefore, the definition of family owned business builds up from all these concepts. It is sure that family business is a complicated set of relationships between the family as an entity, individual family members, and the business itself. The effective management of the overlap between family and business, rather than on resources or processes in either the family or the business systems, is the key ingredients of the success of family firms (Olson et al., 2003).

Beyond the definitions above, type of governance system, management structure, and type of managers in this structure plays a definitive role in defining the family firms. Composition of

corporate board and the top executive position i.e. CEO position are undeniably effecting the both operational and financial performances of family firm.

## **2.2 Corporate Governance System and Family Control**

In the family owned businesses, one of the most crucial problems is the sustainability; and one of the best ways of overcoming this problem is to form a corporate governance system.

According to Gillan and Starks (1998) corporate governance is as the system of laws, rules, and factors that control operations at a company. The pillar of corporate governance is to endorse the core values - accountability, transparency, fairness, disclosure and responsibility; that are pertinent to the success of all business, and are irrelevant to its source (Gulzar and Wang, 2010). System for corporate governance; not only includes the processes, structures, policies and laws for the purpose of managing a company, but also contains the approach of the Board for watching over to the company's operations, and also the accountability of Board Members to the company and its shareholders.

In short, the family business' governance system is the system of structures and processes by which the family business is directed and controlled.

The most outstanding governance mechanism of the internal control system of a firm is the board of directors' structure (Jensen, 1993).

High family involvement and long tenure in management are often characterized with family firms. Thus, family-controlled firms could have better sense of recognizing opportunities and uncertainties, and also long-term planning horizons. This could not only lead to increased continuity, but also stronger patience during the investment period in new business opportunities to create family wealth (Zahra, 2005).

Villalonga and Amit (2006) claim that there are at least three similarities in family business that are: (1) one or more families hold a significant part of the capital; (2) family members have significant control over the company, which is parallel to the distribution of capital and voting rights between non family shareholders, with possible statutory or legal restrictions; and (3) top management positions are held by family members.

Within publicly listed family businesses, if family members control the majority of board seats as CEO, the firm has experienced lower stock market valuation (Wong et al., 2010).

Families are often intended to limit executive management positions to the family members, which is a restriction of labor pool resulting lack of potentially qualified and capable talents; resulting loss of competitive disadvantages relative to non family firms. There are two primary concerns in family CEOs: First, family CEOs' performance is potentially magnified in the family business. The second concern is the cost of excluding more capable and talented outside CEO, since CEO succession is potentially one family member CEO to another family member CEO (Anderson and Reeb, 2003).

However, as far as the board memberships are concerned, study performed by Barontini and Caprio (2005) shows family-controlled firms seem to perform worse than non family firms when the family is not represented in the board. Arosa et al. (2010) stated the independent directors do not improve firm performance. Family management creates value only when the founder serves as the CEO of the family firm or as its chairman with a non family CEO, in contrast descendants destroys value when they serve as chairman or CEO in the firm (Villalonga and Amit, 2006).

McConaughy and Phillips (1999) agreed that founder-controlled firms grow faster and invest more in capital assets and research and development. However, despite the findings of Villalonga and Amit (2006), McConaughy and Phillips (1999) found that descendant-controlled firms are more profitable.

## **2.3 Sustainability and Financial Performance**

Universal definition of the sustainability relates to the factors which influence the ability to help meet today's needs while no sacrifices are made to the ability of future generations to meet their own needs (WCED, 1987).

The sustainability of family business system as a holistic entity and endangers the equitability of family and business system (Danes et. al., 2008). The function of both business success and family functionality is sustainability of a family business (Stafford et. al., 1999).

The key issue of family business sustainability is the need to secure the long term survival and continuity of the business in terms of ownership meanwhile balancing the need to energize the business entrepreneurially and managerially.

Valuable, rare, inimitable and lack of substituted resources around which how well managers build their organizations is a function of firm performance. All assets, capabilities, organizational processes,

firm attributes, information, knowledge etc. that are controlled by a firm, are the resources. For improving its efficiency and effectiveness, those resources make the firm able to conceive of and implement strategies (Barney, 1991).

Efficiencies in terms of utilization of resources and meanwhile the accomplishment of organizational goals are referred to Performance, as broadly defined (Dyer, 2006). Firm performance can be measured by financially and non-financially (Neely et al., 2000). Firm financial performance is to measure the results of a firm's policies and operations in monetary terms.

How well a firm can use assets from its primary mode of business and generate revenues is a subjective measure that is also used as a general measure of a firm's overall financial health over a given period of time. Firms incline to operate in the dark without measurement including the financial ones, since they have no reference to work with.

The two key categories for the measurement of firm financial performance are; accounting based measures and market based measures. Accounting based measurement uses historical data, and is a more backward and inward looking focus. Nevertheless, Nicholson and Kiel (2003) have included ROA as a measure of corporate performance as this is a common measure used in the literature.

Maury (2006) stated that family control is associated with higher firm valuation by using financial ratios of family business. Controversially, Smith and Amoako-Adu (1999) found that long-term industry adjusted return on assets (ROA) improves significantly more with the appointment of non-family insiders and outsiders than family members. According to Brown and Caylor (2009) no former CEO serving on the board is significantly and positively related to Return on Assets (ROA), and positively linked to the operating performance.

Financial performance suffers in case of, first, ownership or control is too concentrated or dispersed, secondly, control is exercised without much ownership, and finally, too many family members clash or drain resources (Miller and Le Breton-Miller, 2006). In finance, the role of family control is under-studied, and the stability of business and long-term planning are secured by family ownership (Chahin, 2007).

In the modern literature, researchers have utilized ROA, ROS and Total Debt/Total Assets, as the most important financial ratios in the measurement of family firm performance. Some of those researchers are Bhagat and Bolton (2008), Navarro et al. (2011), McConaughy and Phillips (1999), Barontini and Caprio (2005), Anderson and Reeb (2003), and Maury (2006). The brief definitions of ROA, ROS and Total Debt / Total Assets are at below.

Return on Assets (ROA) is a profitability ratio ( $\text{Net Income} / \text{Total Assets}$ ). The ROA formula reflects a management's ability to generate income during the course of a given period, usually a year.

Return on Sales (ROS) is a profitability ratio ( $\text{Net Income} / \text{Net Sales}$ ). The ROS shows how efficiently management uses the sales dollar, thus reflecting its ability to manage costs and overheads and operate efficiently.

Total Debt to Total Assets is a debt ratio. It is used to measure a company's financial risk by determining how much of the company's assets have been financed by debt. The lower this ratio generally the better off the company.

### 3. Hypothesis

In this study the hypotheses were made as follows:

H<sub>1a</sub> : There is difference between ROA of Family member CEO and Non family member CEO.

H<sub>1b</sub> : There is difference between ROS of Family member CEO and Non family member CEO.

H<sub>1c</sub> : There is difference between Total Debt/Total Assets of Family member CEO and Non family member CEO.

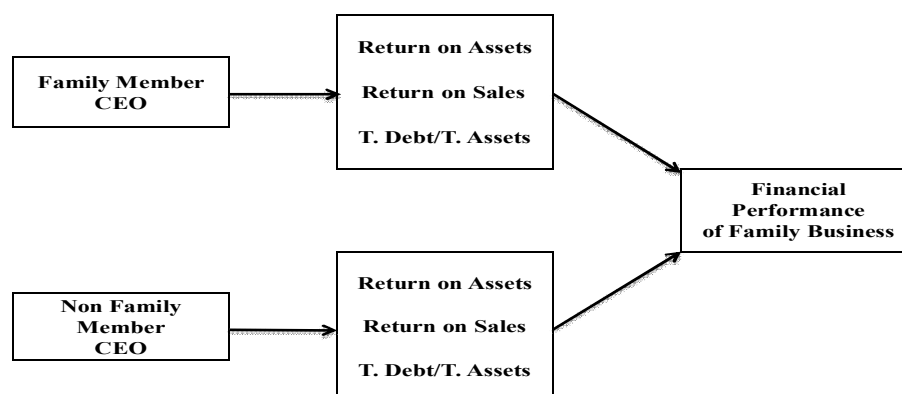
### 4. Methodology

51 companies registered to the Gebze Chamber of Commerce are contacted for the interview via telephone. However, 35 companies declined the request for interview since they do not want to share key financial information for corporate confidentiality policies. For the rest, CEOs of 16 companies are face-to-face interviewed.

All the 16 interviewed companies are family business, of which, 4 companies' 51% or more shares are owned by a single family. The rest 12 companies' 100% shares are under the ownership of a single

family. From the perspective of CEO position, 4 of those companies have non family member CEO and 12 of those have family member CEO.

All the financial data obtained from the companies are from the fiscal year 2008-2010. In this study, Mann-Whitney test is utilized. ROA, ROS and Total Debt/Total Assets were selected as dependent variable. Family member CEO and non family member CEO were selected as independent variable. Diagramme I illustrates the effect of family member CEO and non family member CEO on financial performance of family business.



**Diagramme I.** Model for measuring the effect of family member CEOs versus non family member CEOs on financial performance of family business

### 5. Results

According to the results shown in Table 1, 2, and 3, there is significant difference in ROA criterion regarding family member CEO or non family member CEO. This result is confirmed by descriptive statistic table (Table 4) yielding ROA of family member CEO being 1.6 and non family member CEO 0.428.

As for comparing the Total Debt/Total Assets ratio descriptive statistic table shows the values for family member CEO as 1.216 whereas 0.0950 for non family CEO Total Debt/Total Assets. The difference is significant at 0.0064. In other words, Total Debt/Total Assets ratio of family member CEO is significantly greater.

Finally, for ROS ratio, it can be concluded that there is no significant difference between family member CEO and non family member CEO at 0.2994 significance level.

**Table 1. Mann-Whitney Test and CI: FmemCEOROA; NonFmemCEOROA**

	N	Median
FmemCEOROA	12	1,760
NonFmemCEOROA	4	0,245
Point estimate for ETA1-ETA2 is 1,400		
95,5 Percent CI for ETA1-ETA2 is (0,121;1,880)		
W = 120,0		
Test of ETA1 = ETA2 vs ETA1 not = ETA2 is significant at 0,0338		

As a result, it can be said that family member CEO is more successful in the ROA ratio of the company, but less for the Total Debt/Total Assets ratio. The probable reason is that family member CEO is more likely to make aggressive investment for the future of the company. On the other hand, non family member CEO is less successful in ROA ratio, but more successful in Total Debt/Total Assets ratio. The probable reason is that non family member CEO is more careful about borrowing.

**Table 2. Mann-Whitney Test and CI: FmemCEODebtAssets; NonFmemCEODebtAssets**

N Median		
FmemCEODebtAssets	12	1,2850
NonFmemCEODebtAssets	4	0,0700
Point estimate for ETA1-ETA2 is 1,2350		
95,5 Percent CI for ETA1-ETA2 is (0,5699;1,6400)		
W = 125,0		
Test of ETA1 = ETA2 vs ETA1 not = ETA2 is significant at 0,0064		

**Table 3. Mann-Whitney Test and CI: FmemCEOROS; NonFmemCEOROS**

N Median		
FmemCEOROS	12	0,0800
NonFmemCEOROS	4	0,0300
Point estimate for ETA1-ETA2 is 0,0500		
95,5 Percent CI for ETA1-ETA2 is (-0,0199;0,5000)		
W = 111,0		
Test of ETA1 = ETA2 vs ETA1 not = ETA2 is significant at 0,3026		
The test is significant at 0,2994 (adjusted for ties)		

**Table 4. Descriptive Statistics**

Variables	Abbreviation	Mean	StDev
Family member CEO Total Debt / Total Assets	FmemCEODebtAssets	1,216	0,523
Family member CEO Return on Sales	FmemCEOROS	0,1867	0,2176
Family member CEO Return on Assets	FmemCEOROA	1,600	0,802
NonFamily member CEO Total Debt / Total Assets	NonFmemCEODebtAssets	0,0950	0,0900
NonFamily member CEO Return on Sales	NonFmemCEOROS	0,03250	0,01258
NonFamily member CEO Return on Assets	NonFmemCEOROA	0,428	0,531

## 6. Conclusion

The most common form of business organization is family business in the world. Family businesses have different characteristics which separate them from the businesses owned by diverse shareholders, and these characteristics may result greater efficiency and higher profitability than other firms. Financial performance is one of the most important indicators for family business' sustainability. In the literature, there is no study focusing on relationship between family control and financial performance in Turkey, and this article is an example to fill this gap.

In this study, financial data obtained from the companies regarding the fiscal years 2008-2010. The difference between ROA of family member CEO and non family member CEO, and the difference

between Total Debt/Total Assets of family member CEO and non family member CEO were found significant. Mann-Whitney test was performed for measuring the effects of family member CEO and non family member CEO on the financial performance of family business. Moreover, there is no significant difference between family member CEO and non family member CEO as far as Return on Sales ratios concerned.

The model structured in this study can be expanded by adding other significant financial ratios for making more predictions. As far as the analysis in this study is concerned, following recommendations can be made: Increasing sample size and nation wide sampling. More comprehensive financial data, including market value analysis, longer period of time for financial data can be used.

For further analyses, the following issues can be studied: Founder run family business versus second and more generation run family business for financial performance, Family businesses versus nonfamily businesses for financial performance.

In the literature, there are a limited number of articles about family business in Turkey. Considering the importance of this issue, it is necessary to study of different components of family businesses in Turkey.

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