

International Essays on
Small and Medium Sized
Enterprises

Edited by
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Athens Institute for Education and Research (ATINER)
2010

First Published in Athens, Greece by the
Athens Institute for Education and Research.

ISBN: 978-960-6672-90-3

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Printed and bound in Athens, Greece by THITA Company

14 Solomou Street,
10683 Athens, Greece
www.atiner.gr

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When Corporate Governance Crosses the Firm Borders: Family Firms in Local Productive Systems

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In the context of inter-firm relationships, co-operative relations assume a different nature if it is a familial link. The literature acknowledges the importance of such relationships and has produced a considerable number of writings devoted to the issue, demonstrating its importance in the context of business. It is however, a subject where there remain many research opportunities, due to the richness of the underlying mechanisms.

In this paper two related but different issues are addressed. The first one aims at describing the nature of business when family is at its core, analysing the potential conflicting position of both institutions – the firm and the family, and to establish a parallel, with non-family based firms. The second explores the mechanisms of family management succession.

The theoretical argument underlying this paper is that family-based firms assume different specific features due to the nature and motivation of the ownership and management. For the purpose of this research (due to the nature of the data), a special emphasis is put on the cases where ownership and management correspond to the same individual; and in the cases in which the firm management is conducted by the entrepreneur and hence that the succession occurs within the family. Another aspect of the argument is that the family succession is determined by family structure and that differences in the management style arise from succession, creating a potential conflict within the family.

A substantial part of the scientific study on family-based firms is undertaken from a strategic management perspective, although other perspectives are also important, such as those from resource-based theory. Strategic management perspectives emphasise the role of firms' decisions when a family is at the core of the business (Chrisman *et al.*, 2003; Sharma *et al.*, 1997) and also explore the issue of business succession. Resource-based theory considers family as a strategic resource that firms can use to gain competitive advantage (Zahra, *et al.*, 2004; Chrisman *et al.*, 2003).

At the core of this analysis is the definition of family firms. Although there is a lack of consensus here, the definition is particularly important for the study of the demography of family firms and to evaluate their importance in the context of economies. Watts and Tucker (2006) define a family firm as any enterprise that involves more than one member of the family. However, under this definition, any firm in which, for example, any two brothers work in productive activities, is considered as a family firm. In a more narrow way, Westhead and Storey (1997) consider a family firm, in which at least three of four conditions are met:

- It has undergone an inter-generational transition;
- More than 50% of the shareholding is owned by the family;
- More than 50% of family-members are involved in day-to-day management; and
- Where the firm speaks of itself as a family firm.

This definition is also problematic, as it narrows excessively the definition of the family firm. For the purpose of this work, a family firm is one in which there is a clear involvement of the family in the firm, and that the strategic management of the firm is determined within the family, having more than one member of the family involved in the business.

Arising from any definition of a family firm is the (conflicting) co-habitation of two institutions: the family; and the firm and a matter of high importance is which of them is dominated by the other. Although there is no clear answer for this, Donnelly (1964: p94) argues that "*the balance between family interests and the company interests is usually a psychological one, stemming from the family's own personal sense of responsibility towards the firm.*"

Despite this conflict, there are advantages from organising production around a family. As mentioned before, their own organizational culture is an important strategic resource, which can be used in favour of the family firm. Moreover, when entrepreneurship is embedded in the family itself, it can obtain competitive advantage over their rivals by reducing the cost of operations and making the family firms one of the most efficient organisational forms (Zahra, *et al.*, 2004). There are also advantages in terms of knowledge and the identification of opportunities for entrepreneurship. The argument put forward by Zahra *et al.* (2004) is that the family emphasises the values of the firms, and in the presence of a culture that values the acquisition of new knowledge, the several actors within the firm are constantly exposed to new sources of knowledge. Moreover, in the cases where the founder holds the position for a long time, there is a higher likelihood of an inward focus in the organizational culture.

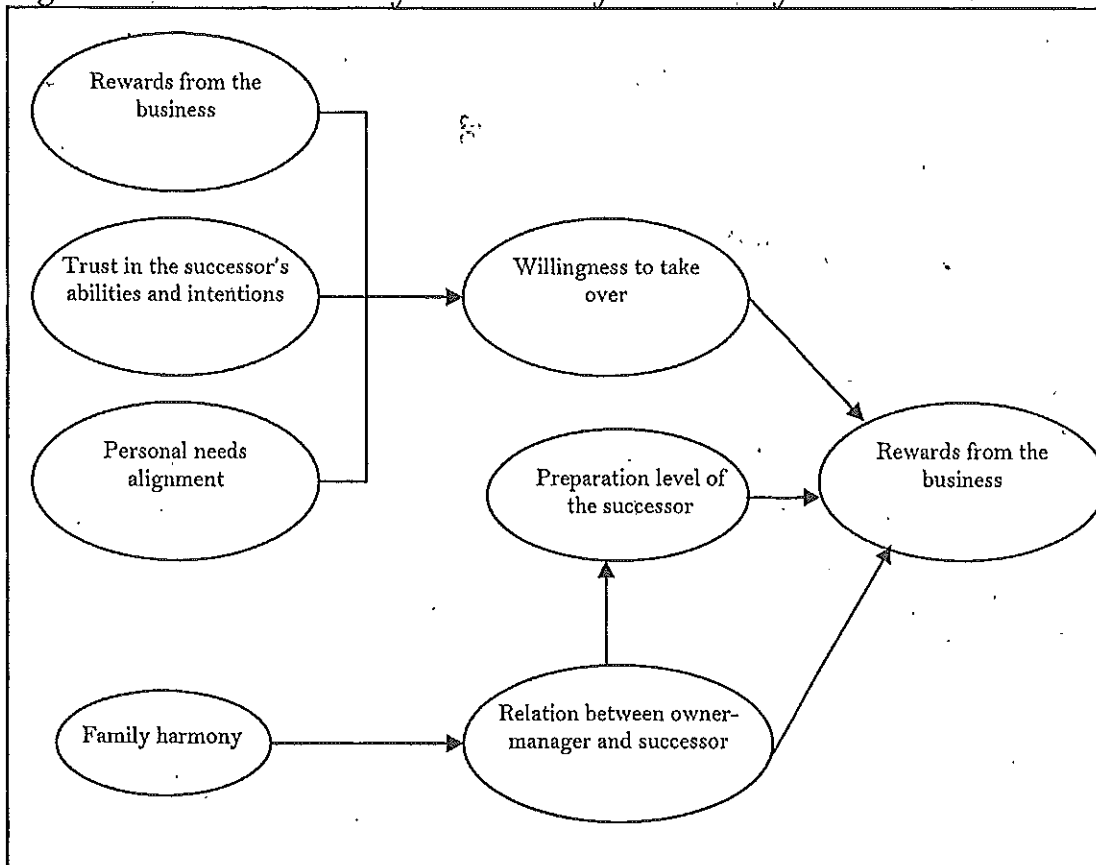
The perspective shown before indicates that within family-based firms there is an amplification of certain values when they are embraced by the family. In the same way (Gallo *et al.*, 2002) found that whenever the family property is shared with non-family members, there is an increased development of shared goals, such as strategic alliances, as much as an increased capacity to trust the non-family shareholders.

However, apparently contradictory, a limitation of family business is in line with the same argument, put forward by Donnelly (1964: 96). According to him "too much involvement with the family interest may prevent a company from

capitalizing on new market developments or on major growth opportunities" due to 'excessive nepotism'. The concept of nepotism is described by Donnelly (1964) as the advancement of relatives on the basis of family rather than merit. This limits the potential growth of the firm as the opportunities that can be offered to non-family management talent are restricted.

Although many of these issues may be common to most business realities, a comprehensive framework of family firms must consider the role of different cultures. Not only in some cultures does the family play a more important role, but also, the organisation of the family itself may differ, impressing different features on to family firms. Although few studies have addressed this problem, it is recognised by Howorth and Ali (2001: p231): "*Indeed, the high level of interdependence between family and business indicate that culture and ethnicity are fundamental to family firms' operation and motivations.*"

Figure 1. Theoretical Model of Factors that influence Successful Succession



Source: Venter, Boshoff and Maas (2005)

The concept of family is hence embedded within the set of local culture, being a social institution with different features across different places. To that extent, the manner in which family firms operate also varies according to the culture. In this sense, the organisation of the family, and the social importance of the family assumes different perspectives and thus, the hierarchy of families may also vary. Accordingly, the way business succession occurs may also be of a disruptive nature.

The succession in family firms is a critical moment for the business, depending on the degree of harmony within the family. Howorth and Ali (2001: p. 233) agree that "*Succession is not always smooth or continuous and can be disrupted by changes in family circumstances or truncated by resistance.*"

The literature agrees that there are a set of factors that affect the success of succession.

The factors affecting business succession are not only related to the successor, but there is also an important role to be played by the founder. In fact, the role of the founder is described as pivotal in determining and sustaining core business values, even after death (Gatrell *et al.*, 2001). Hence, the second generation (and following) are, to some extent, always limited by the legacy of the first generation, not only in terms of the market image of the firm, but also by the existence of a set of norms and conventions, created within the firm that characterise the organisation. Hence the succession is always determined by the founder and generally relies on factors beyond economic rationality. As Howorth and Ali (2001) agree, succession selection may be based on cognitive biases, and relying on personal preferences towards certain family members. As a result the selection of the successor can be based in several criteria: rational business criteria; traditions; emotions; and/or family objectives.

Succession is also subjected to resistance from family members, from different generations. Howorth and Ali (2001) suggest the following factors as obstacles of succession:

- Losing status in the family and in the firm;
- Rivalry by different generations;
- The strong psychological link between the founder and the firm; and
- Difficulties in accepting mortality.

This section has highlighted that family firms base their decisions on different grounds from non-family firms. It was shown that the relationships between family members impress specific features on the relationships within the firms, and more importantly affect business performance in several ways. Although it is not commonly studied in the literature, a different perspective (although analogous) is to explore the inter-firm relationships between businesses conducted by different family members. Although the firms may be independent institutions per se, there is a strong familial link between the entrepreneurs. In line with the theories presented in this section, it seems clear that these relationships are different in their nature from those established by firms with no family connection.

The analysis conducted on family succession is important in the context of this research because there are important management style differences and well as corporate governance mechanisms between different generations, as will be analysed subsequently. It is however, important to understand the internal mechanisms of firms' succession to understand to what extent, the previous generation may impose constraints in the way business is conducted. It was also shown that, in line with the institutional economics perspective, family firms analysis needs to be contextualised within a cultural framework that determines the social nature of the families and hence influence the way family business is conducted.

The Role of Family in the Context of Business

Despite the paramount importance of family business in the context of the overall Portuguese economy, published works on the subject are very limited and gathering relevant data on a macro perspective is difficult. While in some countries (such as the U.K.), it is common to find firms advertising themselves as a family business, it is very rarely mentioned in Portugal. This demonstrates that the fact that a firm is family-based is not a critical factor of success in Portugal. The reasons for this are not so much because there are no expectations of advantages arising from organising a firm around the family, but rather because such practice is very common, and hence not seen as a differentiating factor.

According to Ferreira (2004) firms owned and managed by families represent over 80% of the total Portuguese entrepreneurial fabric, about 60% of GDP and over 50% of employment. These figures show that although a lot of family based firms exist, they are small (in terms of personnel) and contribute less than average to the GDP.

Although the literature about family business for other countries is less limited in scope, some problems arise due to the lack of homogeneous approaches to research. Several studies display important differences in terms of the relative importance of family business in economies. These disparities may be due to the definition of the concept of family business. A study from Donckels and Frohlich (1991) shows the importance of these firms in some European countries and characterise them according to size, as can be seen in Table 1 and Table 2.

Table 1. *Distribution of Family Firms by Size*

Number of employees	%
1-9	77%
10-19	70%
20-49	68%
50-99	51%
>100	50%

Source: Donckels and Frohlich (1991)

Table 2. *Importance of Family Business in some European Countries*

Country	% of family firms
Austria	83
Belgium	69
Germany	82
Great Britain	67
France	60
Holland	53
Finland	63
Switzerland	67

Source: Donckels and Frohlich (1991)

Although this data does not consider the importance of family firms in the Portuguese context, it demonstrates that family is present in business globally

across other European countries. In order to capture some of the Portuguese particularities in family firms, one can use the findings from Howorth and Ali (2001). The most interesting result was that low levels of conflict between generations was found, indicating that family values predominate over business, and also showing the importance and clear definition of the family structure and hierarchy in Portugal. In line with this argument, the authors point out a frequently observed harmony and co-operation between father and son, instead of the rivalry and jealousy found in the Anglo-American literature. Although interesting insights emerged from this paper, the limits of its generality should be stressed, as it is based on only three case studies. However, it has been well documented that family business play a major role in the Portuguese economy and that family as a social structure is well embedded in Portuguese culture, and remains an important institution.

Although no data was found on the subject, it is apparent that family firms are more predominant in the more traditional sectors, as the family institution seems to be playing a smaller role in contemporary society. Hence, longer established firms are more likely to be family-based. It can also be suggested that family-based firms display a more conservative entrepreneurialism, as family values predominate over business.

However, despite playing a major role in the context of the entrepreneurial Portugal, family firms are becoming less predominant.

This work suggests that co-operation operates differently when it is grounded in family values. The characteristics of Portuguese co-operation are highly influenced by the importance of family in the overall business context. Therefore, it is expected that co-operation in general incorporates features of family business relationships and values.

Pros and Cons of Family Firms

Family firms are different for others because there is a set of social values associated to the firm inherent specificities. Gattrel and Kiely (2000) have identified a set of values present in family firms, such as integrity; the desire for success; the commitment with the present and the future generations and thus an increased responsibility in order to guarantee the business success; and the importance of education, religion and public service. Kabanoff (1991) added to these resources the advantages arising from leadership, authority, reward and affiliation.

In light with this argument, there are a number of characteristics that are associated to family based firms that result both in advantages and disadvantages. For a summary of the pros and cons of family firms see the Table 3.

Table 3. Pros and Cons of Family Firms

Factors associated with success	Factors associated with failure
Family members in-depth business knowledge	Shortage of financing opportunities
Family members, high commitment to business	Lack of management capabilities
Remaining innovative and entrepreneurial	The family's growing financial demands tempt owners to harvest the company's profits rather than reinvest them in additional growth
Introducing excellent management training systems	Tendency toward autocracy
Training family members in ownership rights and responsibilities	Reluctance to change
Treating employees fairly and with loyalty is usually reciprocated	Unwillingness on the part of the older generation to 'let go' of ownership and management power at an appropriate moment
Having a strong sense of responsibility to society	Fit between the senior executive's leadership style and company's stage of development
Emphasizing value for money and quality	Inability to attract and retain competent and motivated family successors and non-family managers
Taking decisions quickly as everybody knows where the locus of power is	Sibling rivalry or competition between the generations
Less bureaucracy and quicker decision making	Family members, employment without competence; question of nepotism
Verbal and nonverbal communication can be greatly speeded up in families	Unmanaged conflict between the cultures of the family, the board, and the business
Taking a long-term strategic perspective	Human emotions such as pride or jealousy may become enlarged when home and work are intertwined
The long-term perspective; the company and its products affect the very identity of family members	Authority and responsibility may not be clearly defined; roles in the family and in the business may become confused
The long-term perspective; quarterly results are not driving the business	Decision making hierarchy is bypassed
The family culture and spirit determine the prevailing attitudes, norms, and values in the company	Family tragedies that can accompany business disaster
Special strength from shared history, identity, and common language of families	

Source: Mustakallio (2002: p. 78)

Corporate Governance in the Family Firms

In certain countries family is more commonly found involved in business. Franks *et al* (2005) refer to the UK as a country in which family firms are not predominant in the economic tissue. However, they also refer that there is a large history associated to the participation of the family in enterprises in the UK. The authors refer to the writings of Alfred Chandler who recognises the importance of

family firms in the early 20th century as a dependency of the family business in opposition to the capitalism of professional management. In this regards Frank *et al.* refer commonly known family firms, such as Beechams, Cadbury, Colman, Reckitt, and Rowntree, as firms dominated by the entrepreneur and with very little reliability on professional management. These authors conclude with the description of the modern British Corporative control (since the early 1970s) as an environment with an important institutional participation; a hostile mergers and acquisitions market, and a wide protection of minority shareholders.

Several case studies were found in the literature and these can be used to help on the explanation of forms of corporate governance in family firms. The first of the set of cases is the one founded in Howorth and Ali (2001) whose conclusions refer to the predominance of family values above firm values and thus, these values suggest that it is the family that imposes a set of rules and behaviour patterns. In their study, low levels of conflict between the family and the firm have also been found, which suggests a harmonious acceptance of the family values (which prevail over others) and between generations. The authors refer to a contradictory situation in the succession which is not frequently found in the literature. The authors found for the Portuguese SMEs co-operation between different members of the family (father and son) rather than rivalry.

It is also common to find an emphasis on the feminist values within family firms in Portugal. While it is expected the sons enter into business at a very early stage daughters pursue very often to university studies before entering business. In addition to the family values it has also been found a high level of interaction with the local culture. It seems that the values found locally are also very present within firms and the involvement of family in firms is also part of the local culture. This may also explain the predominance of family firms and the prevailing family values on firms and the harmonious relationships between different generations within the firms. The prevailing role of males in the Portuguese society, on one hand, explains why sons (with low levels of formal education) are preferred over daughters (usually with University education) for the business succession. This leads to a negative situation in the firms, where education seems to have a relatively low appreciation (Guichard and Larre, 2006) and thus firms may lack the opportunity to become competitive given the lack of management knowledge.

The comparison between the Portuguese and the North American family firms may also bring interesting insights. Handler and Kram (1988) describe the American family firms as a system based on performance. In line with the experience of American family firms, Gatrell *et al.* (2001) developed a study based on three case studies of British firms, which provides information about the differences found for the Portuguese business reality. The authoritarian description of the family firms in the UK (in the case study) seems to contrast with smooth relationships found in Portugal. The authors refer to the "fear factor" which is commonly found in family firms. The perpetuity of the family values is also found in the British family firms which are named by the authors as beliefs of the founder; business ability; and the rule of the thumb in decision making. These values are part of the basic structure of the firm and therefore they remain after the founder's death. Despite the relatively low appreciation of the family in the British culture (mainly when compared to Latin countries) there are some nuances of its presence in business. The authors also refer that non family related workers refer to the firm

as "the family business" denoting that these employees see the firm as a long term commitment and that part of the family values are shared as the firm values.

Discussion and Conclusions

The results presented in this section were obtained in interviews with 11 firms and supporting institutions in the furniture industry, mainly located in local productive system – Paços de Ferreira and Paredes (despite some of the interviews were done outside the local productive system). Despite the initial objective of the research has not been the evaluation of the impact of family in business, this theme has emerged quite strongly during the interview stage, justifying the publication of these results in a separate paper. The interviews were done with entrepreneurs - mostly second generation. During the data gathering process it was very evident that first generation entrepreneurs were very reluctant in participating in a scientific research process, denoting the weak appreciation for the results presented by economic academic works. These results can be contextualised in the levels of formal education found amongst first and second generation entrepreneurs, and on the significant increase in the levels of formal education found amongst the Portuguese entrepreneurs. In most of the cases, the results of this research are supported by the results found in the literature.

The involvement of family has shown very relevant to the growth and development of firms. In most of the cases the family was a source of physical and financial resources for the firm (Braga and Andreosso, 2010). In some cases, the family substitutes the banking industry as a financial intermediate, since evidence of the provision of the needed funds was commonly found in the family firms' start-up process.

Another stage of the development of the firm in which the family has a critical role is on the succession of management. In this local productive system it is common practice that one or some of the sons and daughters start their profession lives in the family business (very often after having achieved a university degree) and slowly they take over the management of the firm until the founder abandons the firm completely. The succession process can be potentially generator of family conflicts, being common to be found situations in which sons and daughters divide the firm into different parts as a result of these conflicts. The founder is thus present in all the new formed firms.

The division of the firm is not necessarily a result of a conflicting process. In some situations some firms give place to more than one by a naturally developing process, as a result of a process of division of labour. This is an alternative form of corporate governance, despite the inexistence of a legal link between these firms, there is an informal hierarchy and dependency relationship between these firms, which can be seen as an alternative form of organising the same firm. In these cases strong levels of trust are present within these firms and there are also important and strong increases in productivity, given the division of labour. Although, formally they are separate entities, the process of decision making is not isolate and these firms can be seen as different departments within the same firm. In the cases

in which the firm does not develop into different firms, different sons and daughter assume different roles within the firm managing specific areas of business.

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