

# Comparison of The Ownership and Growth of Family Businesses and Small Firms

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## Abstract

This study examines ownership structure and its affect on the growth of family businesses as compared to small firms. A sample of small manufacturing firms(327) was used to determine if goal conflict exists between managers and owners in small firms. *T-tests* were used to compare the mean growth rates of net sales relative to industry growth rates of various ownership structures. Analysis of the growth of manager-controlled non-family firms versus owner-controlled family firms found manager-controlled firms did not experienced significantly greater relative growth; nor did non-family firms compared to family firms. Various sub-groups of ownership type did demonstrate significant differences as agency theory predicted.

## Introduction

How do family businesses' and small firms' ownership structure affect the growth realized by the firm? Agency theory suggests a relationship between the firm's ownership structure and the strategies the firm pursues; strategy ensues from the ownership structure of the firm, the form of the contract between owners (principals) and managers (agents).

Hoy and Vesser (1994) suggest family business research should examine several topics, two of which are growth of the firm and the ownership of firm. Brockhaus (1994) advances the need for comparative studies contrasting family businesses and non-family businesses. There is very little research combining these topics, comparing family versus non-family businesses (Daily & Dalton 1992; Daily & Dollinger 1992; Daily & Thompson 1994). A few studies have compared other issues (Donckels & Frohlich 1991, Kleinsorge 1994, Gallo 1995).

Agency theory suggests executives pursue personal goals in their strategic decisions which may conflict with owners' goals. Managerial goals include growth, smoothed income streams, enhanced power bases, reduced employment risk and enhanced compensation. These objectives of managers frequently appear to conflict with the profit maximization or increasing shareholder wealth goals of owners. Because of these conflicting goals, owners incur agency costs associated with executive incentive programs and monitoring activities (Stahl & Grigsby 1992). The ownership structure of the firm affects who exercises control of the firm, and for the purposes of this study ownership structure and control will be used interchangeably.

Small firms, as well as large firms, pursue growth-oriented strategies (Cohn & Lindberg 1974; Kuhn 1982). The research on the structuring of organizations suggests that successful firms evolve through several ownership and strategic stages from entrepreneurial single-owner-single business firms to corporate-form diversified firms (Chandler 1962). Research bearing on the efficacy of growth-oriented strategies indicate that growth-oriented small businesses survive at twice the rate of non-growing firms (Phillips & Kirckhoff 1989). These streams of research provide small business managers/owners with incentives to grow.

A large body of research focuses on the Fortune 500 companies in the United States and similar sized firms in other countries. Several researchers report a systematic relationship between diversification strategy and economic performance for Fortune 500 businesses (Rumelt 1982, 1986; Montgomery 1982; Palepu 1985). A few studies examine the strategies of mid-sized firms (Kuhn 1982), but very little research focuses on small businesses. The Fortune 500 firms make up less than 1/10 percent of the firms in the United States. Family businesses make up the majority of firms, mostly small firms and 38 percent of the Fortune 500 (Harris, Martinez and Ward 1994), generating approximately 50 percent of the gross national product (Ward & Aronoff 1990). Small firms, business with less than 500 employees, make up the majority of firms, provide half the jobs and over 40 percent of business sales, a major force in the United States economy (Government Printing Office 1991). The cumulative effects of family and small business strategies have important consequences for the economy as well as for the individual firm.

## **Research Question**

Agency theory has been supported by studies of large firms, but does the theory help small family firms make decisions? How are ownership structure and growth related in family and small businesses?

Agency theory suggests different levels of ownership control of the firm should result in different growth rates. Manager controlled firms should have a preference for high growth to minimize the managers' risks (Amihud & Lev 1981). Owner controlled firms should prefer lower growth (and higher profit) (Holl 1975). Owners, being more risk seeking than managers, would seek higher profits at the risk of less growth. However, family firms, with a long term commitment may be more interested in growth than profit, contrary to non-family owner managed firms and similar to manager controlled firms (Harris, et al 1994).

Research on small businesses identifies several conditions distinguishing small firms from large firms (d'Amboise & Muldowney 1988; Dilts & Prough 1989) that could lead to different results for small firms. First, the restricted options of small firms due to size and resource constraints affect the strategies chosen by the small firm. Small firms may not, for example, have requisite resources or managerial skills to implement diversification strategies. Second, since small firms analyze and interact with their task environment differently than large firms (Shuman & Seeger 1986), a different set of alternatives would be recognized by small firms compared to large firms. Third, the extended internal, interpersonal, interaction found in small firms compared to large firms (Neilson 1974) should lead to greater goal congruence among owners, managers, and employees of small firms. These factors suggest that the effects of agency theory on the small

firm may be different than the effects found in the study of large firms. Family firm research is lacking definitive research in many of these factors, but suggests family interests as opposed to business and/or management interests impact these considerations, thus family businesses may act differently from other firms (Hoy & Vesser 1994).

Theories of organizational growth provide insight into the strategies that owners might use and the relationship to ownership and control. Thompson (1967) argued "our" culture prefers success over failure, and fitness for future action dominates the measure of organization success, not past accomplishments. Using comparison with other organizations as the measure of success, the relative growth of the firm provides a common measure of the firm's fitness. Size differences in firms affect the scale of opportunities and resources, and also affect the methods of accomplishing objectives.

## Hypothesis

Holl (1975) argued that on average, management controlled firms will exhibit higher growth rates and lower profit rates than owner controlled firms. A plot of rates should result in two subgroups of points. His results suggest that owner controlled firms have higher profit rates and lower growth rates than manager controlled firms, with variance and skewness being greater for owner controlled firms as hypothesized. The same results occurred when removing the bias of size among the firms, using matched pairs. When controlled for industry effects using matched pairs, however, these and measures of variance of profit, skewness, and distribution ratio varied in the hypothesized manner but not significantly, suggesting that control type does not affect growth.

McEachern (1978) argued that non-manager owners prefer profit maximization more than owner-managers who may opt for nonpecuniary benefits ("perks"). He found owner-managed firms tended to retain more earnings and accept more stock market risk than either outsider owner-controlled or manager-controlled firms. Returns on common stock were highest for owner-manager firms, then for externally controlled firms, and lowest for managerially controlled firms (Scherer 1980).

Daily and Thompson (1994) found no significant relationship between ownership type and growth in their limited sample. Daily and Dalton (1992) found no differences in financial performance between founder and professional management. However, Daily and Dollinger (1992) did find that family firms pursued more active, growth-oriented strategies than professionally managed firms. Hufft (1994) found the growth of manager controlled small firms was higher than owner controlled small firms.

The extended interaction of owners, managers, and employees of small firms should better align the preferences of owners and managers than would be expected in large firms, thus eliminating agency effects. Thus, both manager controlled and owner controlled small firms, as well as family firms, should exhibit the same goals. Conventional economic wisdom suggests the goal should be profit maximization not growth. Research distinguishing attitudes and behaviors of entrepreneurs (principal purpose profit and growth), small business owners (principal purpose

furthering personal and family goals), and family (long term commitment, importance of family harmony, generations of leadership) provide other views (Carland & Carland 1990; Timmons 1990; Harris, et al 1994). An entrepreneurial owner controlled firm or a family business may exhibit the same preference for growth as a manager controlled firm. Thus, family and small firms may be expected to exhibit similar goals regardless of ownership structure, but what that goal should be differs depending on viewpoint.

The following null hypotheses tests these relationships:

*(1) Non-family businesses will exhibit similar growth rates as family businesses*

*(2) Manager controlled small firms will exhibit similar growth rates as owner controlled small family firms*

For comparison:

*(3) Manager controlled small firms will exhibit similar growth rates as owner controlled small firms*

## Sample

This study used the population of small firms on the personal computer compact disc version of the Disclosures database (1989), consisting of over 12,000 publicly held firms (2971 manufacturing firms), and containing information from annual and quarterly reports, and SEC 10-K filings (Hufft 1993). This study defined "small" as firms with less than 500 employees, total assets of less than \$150 million, and annual sales of less than \$20 million. These points provide the upper bounds of most definitions used in small business research (D'Amboise & Muldowney 1988).

Considering only manufacturing firms, firms in Standard Industrial Classification (SIC) codes 2000 to 3999, minimized, but did not eliminate, industry effects (838 firms). To further minimize the industry bias, the sample included only industries containing small firms with a variety of ownership structures and strategies. An additional constraint on the sample resulted from using only those firms with sufficient data, 327 small firms (see Table 1 for characteristics).

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Table 1 Here  
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## Methods

Ownership structure and growth constitute the constructs for this study. A continuous ratio variable measured growth rate for *t-tests*. The compound change in net sales for the period 1987 to 1990 for each firm measured the growth of the sample firms. To provide a relative comparison of firms in various manufacturing industries, the study compared the firm's growth to the average industry growth of its primary industry, and then used this relative growth to compare firms. The primary industry of the firm provided the factor used to determine relative growth on the assumption that the largest industry the firm participated in had the most effect on growth.

The study did not use a composite average due to a lack of data on the size of each market for the firm. The 1992 Business One Irwin Business and Investment Almanac (1992) provided the mean growth rate of manufacturing industries from 1987 to 1990 used to determine relative growth.

The categorical variables categorized the firms as manager controlled, weak owner controlled, strong owner controlled, manager controlled family firm, weak owner controlled family firm, and strong owner controlled family firm to measured ownership structure. The determination of family versus non-family owned businesses is a matter of much discussion and little consensus. This study defined family businesses as firms owned and managed by one family. The primary determinate was that two or more individuals with the same last name were officers and/or directors of the firm and they owned an interest in the firm, using the SEC 10Q information reported by Compact Disclosure. Daily and Dollinger (1993) examined several methods for distinguishing family firms, both qualitative and quantitative, from directory information, and surveys, to developing a discriminant function and found that they all provided similar results, thus lending support to the simple method used in this study.

In manager controlled firms, the managers and insiders own less than five percent of the firm's stock. Weak owner controlled firms have managers with between five and 30 percent of the stock, and strong owner controlled firms have managers with greater than 30 percent of the firm's stock (see Hufft(1993) for more detailed definitions).

*T*-tests comparing the means of the growth of the various ownership structures tested the hypotheses.

## Analyses

The research questions focus on the differences in rates of growth between different types of ownership structure. Table 2 provides the mean relative growth of net sales for each ownership segment of the sample. *T*-tests provide the method of analyses for testing the hypotheses. Table 2 also provides the tests comparing family owned firms to other small manufacturing firms using several ownership structures.

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Table 2 Here  
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We can not reject the null hypothesis of no difference among family and non-family business by the comparison of all the firms in the study. There was no significant difference between the mean relative growth of net sales of family managed (.0422, n=59) and non-family managed (.0885, n=268) businesses ( $t=1.11$ ). However, non-family managed firms exhibited growth of twice that of family firms which agrees in direction with agency theory. But, Table 2 demonstrates a variety of means among the several possible ownership types. Thus, tests of subsets of the sample provide differing results.

The second null hypothesis of no difference between strong family owned firms and manager controlled non-family small firms also can not be rejected. There was no significant difference between the relative growth of strong family (.0623, n=46) and manager controlled non-family (.2599, n=70) firms ( $t=1.61$ ). But, manager controlled firms did exhibit much higher mean growth as agency theory would predict. The test of the third null hypothesis of no difference between owner controlled and manager controlled small firms found significant differences between the groups, thus rejecting the null hypothesis. Manager controlled small firms (.2535, n=72) did exhibit higher mean growth than strong owner controlled firms (.0409, n=154,  $t=1.84$ ,  $p<.10$ ) and weak owner controlled small firms (.0165, n=101,  $t=2.01$ ,  $p<.05$ ). Comparing only small non-family owned firms found similar results. Thus, the whole small firm sample found support for using agency theory as a means for understanding small firms, results similar to Hufft (1994) using Mann-Whitney tests.

Dividing the family-managed firms into subgroups found 46 of the 59 family firms were strong owner controlled firms (ie. ownership greater than 30 per cent) whose mean growth (.0623) was similar to non-family manager controlled firms (.2599, n=70,  $t=1.61$ ), similar to the whole sample results supporting the null hypotheses 1 and 2. Two family firms had ownership with less than five percent controlled by the family, an unexpected level for family firms. The sample size was too small to draw meaningful conclusions; but, mean growth for the two firms was one third the growth of strong family controlled firms and one tenth the growth of non-family manager controlled firms. Eleven (11) family firms were classified as weak owner controlled with a mean relative growth rate of -0.0394 which was significantly less than the manager controlled non-family firms ( $t=2.27$ ,  $p<.05$ ), rejecting the null hypothesis and supporting an agency theory explanation. There were no significant differences between strong owner controlled firms and weak owner controlled firms, either family or non-family firms.

## Discussion

This study found that there were no significant differences between the growth rates of family managed and non-family managed businesses, though non-family businesses did exhibit twice the growth of family firms. The study found as the managers' ownership of the small manufacturing firm increased (the firm became more owner controlled), the rate of growth of the firm declined as predicted by theory whether family controlled or not. Interesting, strong owner controlled family firms were not significantly different than non-family manager controlled firms, contrary to agency theory, suggesting that the long term commitment of the family may lead to greater emphasis on growth similar to manager controlled firms. Weak owner controlled small firms and family firms both have significantly lower growth rates than manager controlled firms supporting agency theory. This suggests that the dilution of ownership in the weak owner controlled firm may be a primary reason that both non-family and family firms, with manager ownership in the 5 to 30 percent range, have less growth than other firms,

possibly due to a different set of goals. Manager controlled small firms exhibited higher rates of growth than owner controlled firms. This supports agency theory and the proposition that managers act in their own behalf, not necessarily the firm owners' behalf. However, the two manager controlled family firms had significantly less growth (.0295,  $t=1.9$ ,  $p<.1$ ) than the non-family manager controlled firms. This could be due to much higher net sales (\$14.4M vs. \$7.5M) and gross profits (\$8.0M vs. \$2.8M) than the other manager controlled firms and all other firms in the sample. Dilution of ownership perhaps goes hand in hand with increased size. If the firms went from weak control to manager control perhaps profit goals are still the primary goals, not additional growth.

This study provides a means to determine the growth posture of small manufacturing firms based on their ownership structure. These results suggest families, small business owners and/or investors should determine their objectives for the firm, explicitly communicate the objectives to the family and non-family managers, and monitor the performance of the firm to insure the decisions made by managers support the owners objectives, not the managers objectives.

Future study should examine all types of family firms to determine if similar relationships exist. Additionally, different measures of the outcomes of ownership strategy should be explored to determine the factors that influence performance the most to better inform decisions.

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**Table 1**  
**Descriptive Statistics**  
**Representative Measures**

Measure	Total sample		Non-Family		Family Firms	
	Mean	SD	Mean	SD	Mean	SD
<b>Net Sales \$M</b>	7.56	5.69	7.45	5.69	8.06	5.72
<b>Gross Profits \$M</b>	2.85	2.85	2.85	2.91	2.85	2.55
<b>Employees</b>	89.9	68.9	88.1	66.7	98.2	78.3
<b>Growth Net Sales</b>	.1260	.519	.1353	.565	.0839	.205
<b>Industry Growth Net Sales</b>	.0436	.0329	.0443	.0329	.040	.0332
<b>Relative Growth Net Sales</b>	.0802	.4995	.0885	.5442	.0422	.1932
<b>Manager Ownership %</b>	22.2	26.4	20.1	24.2	31.6	33.5
<b>Sample Size</b>	327		268		59	

**Table 2**  
**Comparison of Relative Growth of Net Sales**  
**by Ownership Structure**

Ownership Type	NonFamily vs. Family					Manager vs Subgroups			Small Firms			
	Nonfamily Firms		Family Firms		Difference In Means	Nonfamily Manager Controlled		Difference In Means	All Manager Controlled	Difference in Means		Sample Size
	Mean	SD	Mean	SD	t-value	Mean	SD	t-value	Mean	SD	t-value	(NF/All)
<b>Nonfamily Firms</b>	.0885	.544	.0422	.193	1.11							327
<b>Manager Controlled</b>						.2599	1.0	-	.2535	.9872	-	70/72
<b>Weak Owner Controlled</b>						.0233	.1852	1.88 <sup>^</sup>	.0165	.1851	2.01*	90/101
<b>Strong Owner Controlled</b>						.0318	.1966	1.88 <sup>^</sup>	.0409	.1964	1.84 <sup>^</sup>	108/154
<b>Family Firms</b>	-	-	-	-	-							
<b>Manager Controlled</b>						.0295	.028	1.9 <sup>^</sup>				2
<b>Weak Owner Controlled</b>						-.0394	.1832	2.27*				11
<b>Strong Owner Controlled</b>						.0623	.1964	1.61				46
<b>Sample Size</b>	268		59									

(<sup>^</sup> p<0.10, \* p<0.05)