



CAN AGENCY THEORY RECOMMENDATIONS AFFECT  
PERFORMANCE OF FAMILY FIRMS? EVIDENCE FROM THE ITALIAN  
MARKET

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**Abstract**

Using data on all family owned firms listed on the Italian Stock Exchange for the entire period between 2001 and 2005, it is shown that agency theory prescriptions and monitoring activities differentially impact the market value and profitability of family owned firms. Specifically, non-founder family firms benefit from a low level of board and insider stock ownership and a high level of stockholder and foreign investor ownership, because these firms necessarily face high agency costs. Conversely, founder family firms benefit from a high level of board and insider ownership, and a low level of stockholder and foreign investor ownership, owing to their lower agency costs.

**Keywords:** corporate governance, family firm, ownership structure, performance

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**1. Introduction**

Romano et al. (2001) argue that all firms must attract external financing in order to achieve the full profit potential of the business. Unique structural features of family firms place the need for financing in a quite different context owing to family ownership and control objectives, specifically the desire for continuity of family involvement, that characterize family firm capital structure decision-making.

The Italian family business context is very specific, since, as De Laurentis (2005) and Caselli (2005) noted, firms are often owned, controlled and managed by founding families. This situation is evident in both large companies and SMEs. Moreover, this control is very strong and frequently management of the firm is shaped by family

objectives. Nevertheless, as Chami (2001) demonstrated using an international sample that included Italian firms, Italian family businesses do not suffer the consequences of agency cost since the whole organization is aligned with the interests of the owners (Trento and Giacomelli (2004); Giannetti (2003)), even though they must often overcome delicate situations relating to successional and “dynastic” issues (Caselli and Gennaioli (2003)).

When Caselli and Gatti (2006) examine the performance of Italian IPOs categorized by whether they were family or non-family businesses, they find an odd situation. Even though they show a strong and generalized IPO underperformance by family firms, and a positive impact on long-run stock market performance of strong family involvement, firm age is, counter intuitively, a negative influence.

These differences could be due to divergences in corporate governance and ownership structure or to different agency cost frameworks, in accordance with the findings of Berle and Means (1932) insofar as ownership structure should enable corporate management to realize the full potential of corporate assets. Clearly for Italy, the relationship between corporate governance and performance in family firms is poorly understood, and above all, has thus far been characterized in a limited manner, probably owing to the difficulties in applying and evaluating agency costs correctly.

In line with recent work (Randoy and Goel (2003), Mishra, Randoy and Jenssen (2001), and Steier (2003)), this study suggests that firms with founder family leadership exhibit a unique governance system whereby the problem of agency cost takes second place to the priority of access to resources. As a result, all governance structures that aim to reduce agency costs are irrelevant in the context of family control; in fact, the presence of such large shareholders does not involve cost reductions, so leads to lower performance. On the other hand, this high level of inside ownership can lead to strategic benefits and thus to superior economic performance.

The empirical evidence calls for a deeper analysis, an acceptance of the challenge put forth by Jayaraman, Khorana, Nelling and Covin (2000) that calls for empirical research concerning the predictive power of “types of organization and corporate governance systems used by family firms (with or without the founder)” on long run performance.

## **2. Literature review**

### **2.1. Founder family control effects on corporate governance and long run performance**

Pieper (2003) reviews the state of research on family business governance, citing many empirical studies concerning the link between performance and family firm governance. Nevertheless, as he does not focus on financing for family firms, his conclusions cannot guide or inform our research.

James (1999), Danco (1975), and Poza (1989) affirm that the reduction in agency costs in family firms is greater than in other firms and, furthermore, increases continuously, owing to the atmosphere of love and commitment created by the founder's leadership. Mishra et al. (2001), McConaughy, Matthews and Fialko (2001), and Kang (1998) study the characteristics of corporate governance systems in founder family managed firms (i.e., firms where the original founder is still the CEO or the chair). They find an outperformance that disappears when the founder or the founder family sells its ownership or otherwise stops working at the firm.

Anderson and Reeb (2003) show that it is impossible to support the hypothesis that continued

founder family majority ownership in public firms leads to minority-shareholder wealth expropriation. So, they conclude that families do not use their firms to maximize personal interests.

Lee (2004), quoting the findings of Anderson and Reeb (2003), sheds light on the profit and loss dimension of family firms and shows that family ownership and management yields greater efficiency and productivity, particularly in founder family firms. Carney (2005) concludes that the competitive advantage of family controlled firms arises from their system of corporate governance.

Klein, Shapiro and Young (2005) analyze the relationship between performance and corporate governance in Canada and find that the presence of independent directors on founder family firm boards of directors generates poorer economic and financial results. Filatotchev, Lien and Piesse (2005) perform the same analysis for Taiwan and discover that family control does not correlate with conventional performance measures such as accounting ratios, sales per issued capital, earnings per share and market-to-book value, but, contrary to Klein, Shapiro and Young (2005), they conclude that board independence from the founder family and board members' own financial interests have a positive impact on performance.

Oreland (2005) shows that the level of product market competition moderates the relationship between founder family leadership and firm performance such that firms led by the founder family perform poorly (are least profitable and show lower firm value) in highly competitive industries.

Anderson, Mansi and Reeb (2003) investigate the impact of founder family ownership structure on the agency cost of debt. They find that founder family ownership is common in large, publicly traded firms and is related, both statistically and economically, to a lower cost of debt financing. Their results are consistent with the idea that founder family firms have incentive structures that result in fewer agency conflicts between equity holders and debt claimants. This suggests that bond holders view founder family ownership as an organizational structure that better protects their interests. These findings are in accord with the studies of Johnson, Magee, Nagarajan and Newman (1985), Morck, Shleifer and Vishny (1988), and Gomez-Mejia, Nunez-Nickel and Gutierrez (2001) that suggest that founder CEOs are associated with strong performance early in their careers, poorer performance in later years, and that family member CEOs are more entrenched in their positions.

Finally, as Randoy and Goele (2003) emphasize, “there is evidence from studies that indicate that entrepreneurs and founder family are more exposed to managerial entrenchment and therefore potentially associated with weaker performance (Thomsen and Pedersen (2000)) [...] but there are other studies that reveal inconsistent results (Begley (1995); Dalton and Daily (1992)).”

## **2.2. The relationship between ownership structure and performance**

A number of theories of board behavior have been developed over time. A brief review of these is given by Stiles and Taylor (2001). One of the most important is agency theory, which focuses on the agent-principal relationship to further understanding of the governing board. The agency relationship (or agent-principal framework) is a contract under which one or more persons, the principals, engage another person, the agent, to perform some services on their behalf. This involves delegating authority to the agent. Agency theory incorporates important assumptions about managerial behavior being self interested, such as moral hazard, and evincing bounded rationality. According to Gompers, Ishii, and Metrick (2003), agency theory regards the board of directors as an instrument of control.

Another interesting approach is stewardship theory, which proposes that there is no conflict of interest between managers and owners and that to be successful, the organization requires the structure that best facilitates coordination between managers and owners. Muth and Donaldson (1998) found that stewardship theory — in contrast to the agency theory — recognizes a range of non-financial motives of managers described in the occupational psychology literature. Examples include need for advancement and recognition, intrinsic job satisfaction, respect for authority, and work ethic.

To test the above-mentioned theories, several studies examine the relationship between board composition and company performance, either by country or by specific firm type, such as publicly-owned, fast-growing, venture-backed, or family-owned (i.e., La Porta, De Silanes, and Shleifer (1999)). Villalonga and Amit (2004) deepened the focus on family owned firms, testing relationships among performance, rules of governance, and board composition. In particular, they find that the effect of blockholders is significantly more negative for non-family firms than it is for family firms. This finding suggests that families play a moderating role in the agency conflict between other large shareholders and minority shareholders.

Faccio and Lang (2002) examine corporate governance rules with specific attention to the effects of institutional investors sitting on boards; but they do not specifically focus on family firms.

Hansell and Hill (1991), and Kroll, Wright, Toombs and Leavell (1997) investigate the specific role of ownership structure on firm performance and show that blockholder ownership in non-founder firms allows for greater outside monitoring of corporate governance. Moreover, as shown by Kang (2000), institutional investors intervene to improve firm performance, exploiting their “political influence” (the same activity engaged in by private equity operators in their participated firms, as Caselli

and Gatti (forthcoming) report in their literature review).

Smith and Amoako-Adu (1999) say that firms with multiple family members occupying senior management positions and that lack outside blockholders are more likely to appoint a family member as successor and do not apply measures of corporate governance in order to improve firm management.

Schulze and Dino (1999), as Wright, Ferris, Sarin and Awasthi (1996) had already noted, affirm that agency theory cannot be applied to firms with highly concentrated ownership and that the agency position of each family board member is likely to diverge when ownership becomes more diffuse. As a result, blockholders in family firms maintain harmony, accord and strategic agreement among themselves.

Fernandez and Nieto (2006) examine the relationship between the internationalization strategies of SMEs and types of ownership. They observe a negative correlation between family ownership and export intensity, confirming the conclusions of Kets de Vries (1996) and Poza (2004). Moreover, they support the conclusions of Schulze, Lubatkin and Dino (2003), and show that when ownership is concentrated or when ownership and control are in the same hands, firms tend to show poor performance owing to the need to satisfy both family and business interests simultaneously. Nevertheless, this limitation does not seem to present itself in family firms that have an outside corporate investor.

Oreland (2005) obtains new findings from examining the Swedish market; family control, per se, leads to slightly worse firm performance than a dispersed ownership structure with a professional manager in control. In particular, founder family firms and highly concentrated ownership family firms have lower performances.

Tiscini and Di Donato (2006) analyze how investors perceive risk in family firms and find a negative relationship between family ownership and agency risk, whatever the level of family participation.

Miller and Le Breton-Miller (2006) analyze both the agency and the stewardship theories and conclude that the picture for family firms is multifaceted. Their findings suggest that family controlled firms do best when they take advantage of the potential for lower agency cost and work to elicit attitudes of stewardship among leaders and majority owners. This is most apt to occur when voting control requires significant family ownership, when there is a strong family CEO without complete voting control and who is accountable to independent directors, when multiple family members serve as managers, and when the family intends to keep the business for generations. Often, these conditions are found in an established family business still operated by its founder.

Bekaert and Harvey (2000) or Stulz (1999) distinguish between family firms by participation or non-participation by foreign owners and they conclude that the involvement of foreign investors improves firm performance, whatever the family equity contribution or the presence of the founder.

### 3. Testable hypotheses

As the empirical evidence is unable to explain the relationship between corporate governance and firm performance in founder and non-founder family firms in a clear manner, a foundational idea is required to develop testable hypotheses. In our empirical evidence, the same suggestions and hypotheses developed by Randoy and Goel (2003) are tested, even if the focus is not on the world of SMEs, but on that of Italian family firms.

Randoy and Goel (2003) argue that founder leadership is a substitute corporate governance mechanism that can replace other monitoring mechanisms such as direct surveillance by owners. These authors show that founder family firms operating under a governance structure that is best suited for firms with relatively high agency costs incur cost redundancies. Consequently, a lower performance should be found in founder family firms with conventional corporate governance mechanisms.

A high level of board and insider ownership creates favorable conditions for managerial entrenchment and self-aggrandizing behavior and, at the same time, reduces the owner's ability to monitor and control the management. This phenomenon is very problematic in non-founder family firms because of the lack of the founder's creative leadership. Thus, a lower performance should be prevalent in non-founder family firms.

The effect of the presence of blockholders creates a very different effect. Blockholders have the ability to reduce agency costs in non-founder firms through a high level of active monitoring and a high degree of involvement in a company's decision making processes. Conversely, founder family firms have less need for outside screening, since the family has control of the developed business concept. Moreover, blockholders may have a more conservative view of entrepreneurial prospects than a founder family. For these reasons, superior performance should characterize non-founder family firms that have a significant presence of blockholders.

The same conclusions hold for foreign ownership. Foreign owners usually engage in stronger monitoring of managers and reduce agency costs. Nevertheless, it should be noted that foreign owners may be less familiar with the local entrepreneurial opportunities that are available and known to founder family firms. Such ignorance, combined with their requests for additional reporting, both in terms of content and frequency,

may add costs without corresponding benefit. So, foreign ownership in founder family firms may yield no advantage and could generate poorer performance.

Accordingly, the following hypotheses are tested:

*H1-a. A high level of ownership control by board members has a negative influence on firm value in firms lacking a founder family CEO or chair.*

*H1-b. A high level of ownership control by board members has a negative influence on firm profitability in firms lacking a founder family CEO or chair.*

*H2-a. A high level of blockholder ownership has a positive influence on firm value in firms without a founder family CEO or chair.*

*H2-b. A high level of blockholder ownership has a positive influence on firm profitability in firms without a founder family CEO or chair.*

*H3-a. A high-level of foreign ownership has a positive influence on firm value in firms lacking a founder family CEO or chair.*

*H3-b. A high level of blockholder ownership has a positive influence on firm profitability in firms lacking a founder family CEO or chair.*

### 4. Data and methodology

Borsa Italiana SpA (the Italian Stock Exchange (ISE)) and AIdAF (the Italian Family Firms Association) made available the data required to develop this empirical research. The subject sample is comprised of all family firms listed on the ISE for the entire period between 2001 and 2005, and consists of 128 firms.

To test the hypotheses, the sample universe has been divided into two sub-samples: founder family firms (76) and non-founder family firms (52). Founder family firms are those in which the founder is still the leader of the firm; that is, he is the CEO and/or the chair.

ISE provided data concerning the following parameters: the yearly average market capitalization for each firm, the composition of the board and insider participation, blockholder participation (name and commitment of each participant), foreign participation (name and commitment of each participant). AIdAF provided financial data (book value of assets, ROA, plant value, sales, financial debts, etc.) using firms' annual reports, and other information concerning the firms (age, sector, etc.) gathered through direct interviews.

For each firm, some measures are estimated in order to facilitate development of a statistical model:

– Firm value. Firm value is the ratio between the market value of a firm and the book value of total assets. Market value of a firm is the sum of the market value of equity and the book value of total liabilities. This measure, as Perfect and Wiles

(1994), and Chung and Pruitt (1994) suggest, can be taken as a correct approximation of Tobin's Q. Firm value is calculated for each year in the period 2001-2005;

– ROA. Nickell (1996) suggests that ROA, which is an accounting-based measure, cannot detect the effects of ownership structure directly; so he proposes to use a 1-year lagged ROA. In our empirical evidence, ROA is the ratio calculated using the previous year's EBIT (the numerator) and the book value of assets (the denominator);

– Founder / non-founder firm. This is a dummy variable that takes the value 1 if the CEO and/or the chair are the founder, and 0 otherwise. This measure is used to create interaction variables in order to understand differences between founder family firms and non-founder family firms;

– Board insider ownership. Percentage of all shares owned or controlled by board members and the CEO/chair;

– Blockholder ownership. Percentage of ownership of all shares by the three largest shareholders;

– Foreign ownership. Percentage of total equity held by foreign citizens or foreign institutions.

As past research indicates that results in this field of investigation could be affected by firm-

specific items, some control variables are calculated in order to avoid biases:

– Asset tangibility. This is the ratio of net property, net plant and net equipment over total assets at the end of the year;

– Debt ratio. This is the ratio of debt to total assets at the end of the year;

– Firm size. This is a logarithm of total revenues (in millions €) for each year;

– Firm age. This is a logarithm of the number of years between the observation year and the firm's founding year.

A cross-sectional OLS regression model is used to test the hypotheses. The dependent variables are firm value and ROA, while founder / non founder firm, board inside ownership, blockholder ownership, foreign ownership, asset tangibility, debt ratio, firm size, and firm age are the independent or control variables. As this approach is susceptible to heteroscedasticity and multicollinearity problems, a check of all variables is made before the OLS regression, but the analysis does not indicate any harms.

Table 1 enumerates descriptive statistics from the analyzed sample.

**Table 1.** Descriptive statistics

Variables	Full sample (N=128)		Non-founder firms (N=52)	Founder firms (N=76)
	Mean	Standard deviation	Mean	Mean
<i>Dependent variables</i>				
Firm value	4.68	3.15	4.04	5.11
ROA (%)	13.38	19.24	12.11	14.25
<i>Independent variables</i>				
Board and inside ownership (%)	9.17	33.15	10.21	8.45
Blockholder ownership (%)	61.10	21.56	55.14	65.18
Foreign ownership (%)	8.75	6.25	9.56	8.19
Asset tangibility (%)	48.64	31.41	52.1	46.28
Debt ratio (%)	59.99	12.36	65.42	56.28
Firm size	3.81	1.11	3.85	3.78
Firm age	4.12	1.33	4.27	4.02
<i>Other data - not in the model</i>				
Founding year	1961		1959	1962
Founder and family ownership (%)	49.20		40.36	55.25

## 5. Empirical findings

Table 2 summarizes the main findings and the interaction effects of the multivariate regression model applied to Italian listed family firms. The statistical model and the employed variables are valid as the adjusted  $R^2$  is 0.351 when firm value is the dependent variable and 0.428 when the dependent variable is ROA. Interaction effects can explain the hypotheses directly as they assume value only when the item "Founder / Non founder" is equal to 1, that is when the founder is still CEO or chair.

Hypotheses 1-a and 1-b are supported completely, so it can be stated that board and insider ownership improve the performance of founder family firms and they provide no tangible contribution to non-founder family firms. The

remaining hypotheses are more difficult to support and to comment on because, on the one hand, propositions 2-a and 3-b are confirmed, but, on the other hand, propositions 2-b and 3-a are not shown to be statistically significant, even if the direction of the relationship is confirmed (there is a negative relationship for both blockholder and foreign ownership). In other words, a high level of foreign ownership has a positive influence on firm value in firms without a founder family CEO or chair, but has no consequence on the firm's economic performance; and a high level of blockholder ownership has a positive influence on firm profitability in firms without founder family CEO or chair but does not affect firm value.

**Table 2.** Interaction effects in multivariate analysis

Variables	Dependent variable: firm value		Dependent variable: ROA	
	Beta value	t-value	Beta value	t-value
<i>Independent variables</i>				
Founder / Non founder	0.325	(1.115)	-0.075	(-0.385)
Board and inside ownership (%)	-0.101	(-0.874)	-0.519	(-2.851)**
Blockholder ownership (%)	0.118	(1.365)	0.381	(2.514)*
Foreign ownership (%)	0.421	(4.236)***	0.058	(1.067)
<i>Control variables</i>				
Asset tangibility (%)	-0.021	(-0.687)	0.308	(2.651)*
Debt ratio (%)	0.103	(0.275)	-0.614	(-2.008)*
Firm size	-0.229	(-2.945)**	0.421	(6.284)***
Firm age	-0.001	(-1.211)	-0.236	(-1.914) <sup>o</sup>
<i>Interaction variables</i>				
Founder * Board and inside ownership	0.961	(2.128)*	0.746	(5.252)***
Founder * Blockholder ownership	-0.456	(-1.248) <sup>o</sup>	-0.412	(1.465)
Founder * Foreign ownership	-0.314	(-1.596)	-0.331	(-4.197)***
Adjusted R2	0.351		0.428	
F-statistics	5.891***		8.410***	

t-test: two-tailed

<sup>o</sup>; \*, \*\*, \*\*\*: significance at 10%; 5%; 1%; 0.1%, respectively

To contrast these results, a second regression was performed, in which founder family firms and non founder family firms are taken into consideration. Table 3 summarizes those results.

Even applying this regression model, hypotheses 1-a and 1-b are supported, so insider holding stimulates performance in founder-owned firms but reduces it in non-founder family firms. As far as hypotheses 2-a and 2-b or 3-a and 3-b are concerned, our findings

provide only partial support since not all results are statistically significant, even if the predicted sign is correct in all cases.

In summary, non-founder family firms derive advantages from greater monitoring by large blockholders and/or foreign investors, which consent to distinguish entrepreneurial activity from strategies implemented by managers in order to maximize their own personal objectives. So, a self-aggrandizing board and insider ownership lead to negative performance, because of the lack of control and the high agency costs due to hired managers. For

founder family firms, the situation is completely different because a high level of insider ownership has a positive impact on firm performance, while the monitoring provided by large blockholders and foreign investors has a negative effect. This is because the governance context faced by founder led family firms provides relatively little incentive for self-dealing, so the additional monitoring by large blockholders and foreign ownership is not useful in exploiting and to financing entrepreneurial opportunities.

**Table 3.** Ownership structure and family firm performance

Variables	Non founder firms		Founder firms	
	Firm value Beta value ( <i>t</i> -value)	ROA Beta value ( <i>t</i> -value)	Firm value Beta value ( <i>t</i> -value)	ROA Beta value ( <i>t</i> -value)
<i>Independent variables</i>				
Board and insider ownership (%)	-0.442 (-1.895) <sup>o</sup>	-1.215 (-3.332) <sup>***</sup>	1.459 (1.928) <sup>o</sup>	1.035 (3.164) <sup>**</sup>
Blockholder ownership (%)	0.238 (1.268)	0.523 (2.794) <sup>**</sup>	-0.603 (-1.895) <sup>o</sup>	-0.321 (-0.764)
Foreign ownership (%)	0.625 (6.631) <sup>***</sup>	0.006 (1.031)	-0.016 (-0.325)	-0.577 (3.130) <sup>**</sup>
<i>Control variables</i>				
Asset tangibility (%)	0.02 (0.725)	0.608 (2.852) <sup>**</sup>	-0.495 (-2.999) <sup>**</sup>	-0.01 (-0.167)
Debt ratio (%)	-0.115 (-1.987) <sup>*</sup>	-1.249 (-2.733) <sup>**</sup>	-0.028 (-0.023)	-0.152 (1.067)
Firm size	-0.695 (-1.932) <sup>o</sup>	0.271 (2.219) <sup>*</sup>	-0.729 (-1.302)	0.625 (3.942) <sup>**</sup> *
Firm age	-0.756 (-1.412)	-0.724 (1.316)	-0.003 (-0.164)	-0.308 (2.258) <sup>*</sup>
Adjusted R2	0.428	0.253	0.375	0.621
<i>F</i> -statistics	8.264 <sup>***</sup>	3.335 <sup>***</sup>	3.385 <sup>***</sup>	7.619 <sup>***</sup>

*t*-test: two-tailed

<sup>o</sup>; <sup>\*</sup>; <sup>\*\*</sup>; <sup>\*\*\*</sup>: significance at 10%; 5%; 1%; 0.1%, respectively

## 6. Conclusions and further research

The basic premise of this study is that agency theory prescriptions are relevant in non-founder family firms but are redundant in family firms with founder leadership. Employing the whole universe of family

firms listed on the ISE for the entire period between 2001 and 2005, the impact on firm performance of various corporate governance mechanisms is tested. In particular, performance can be modeled as lagged ROA (that is, the previous year's ROA) or as firm value (approximated by a simplified version of

Tobin's Q), while the types of governance considered are: ownership of boards, blockholders, and foreign investors.

Even if our results are not statistically significant, they always confirm the predicted direction of the relationship and they prove that the agency context for founder and non-founder family firms is quite different. Founder family firms operate in a low agency cost environment, so the monitoring activities of blockholders and foreign investors can be a drag on firm value and profitability, as they are not free of cost and they do not provide any incremental benefit. In such a firm, benefits come from board and insider ownership, because the presence of the founder limits the self-dealing of management and overall firm strategies are better implemented.

For non-founder family firms, whose management is exercised by persons outside the family, performance is positively affected by the monitoring activities of blockholders and foreign investors; they reduce managerial entrenchment and the divergence of interests between ownership and management. So, in these cases, board and insider ownership generate poorer performance and are not the ideal solution for corporate governance.

Our findings suggest that different agency contexts exist, and that the traditional separation between ownership and management should be more deeply examined. In fact, this separation does not always lead to high agency cost. For this reason, corporate governance mechanisms must be evaluated from both the cost and benefit perspectives since they could determine a firm's final performance.

There are practical implications for firm financing as well. Founder family firms seem to have more difficulty finding funding, even from private equity investors. This is because these actors usually rely on corporate governance and board ownership as mechanisms to mitigate agency costs. Non-founder family firms, on the other hand, should exploit any ownership structure that facilitates better monitoring and new shareholder participation.

Family firms with transition and succession problems might see the findings of this study as extremely useful. Founder family firms in which families intend to reduce their involvement should strengthen alternative corporate mechanisms aimed at limiting the value destruction that an abrupt exit without any governance safeguards can generate.

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