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CONTRACTUAL AND RELATIONAL GOVERNANCE IN FAMILY FIRMS: EFFECTS ON STRATEGIC DECISION-MAKING QUALITY AND FIRM PERFORMANCE

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ABSTRACT

This dissertation aims to contribute to research on family firm governance, an area that has attracted only little attention in the past. Governance of family firms differs from corporate governance of diffusely-owned, large corporations because important owners, i.e. the owner family members, may have multiple roles in the business, and because relationships between key stakeholders are enduring, and the shares of family firms are, to a degree, illiquid. Because of such characteristics, the governance of family firms presents a distinctive challenge for research and practice. The overall research question of the dissertation is: What are the impacts of the governance mechanisms on the performance of family firms? The study specifically focuses on relationships between family firm governance and strategic decision-making quality, defined in terms of decision quality and decision commitment.

This study develops and tests two models of family firm governance, one focusing on "contractual," and the other on "relational," governance. Mirroring the prescriptions of agency theory, contractual governance addresses aspects of the formal control exercised by the boards of directors. The contractual governance model argues that ownership structure determines the composition of the board of directors, and that representation of outside members on the board influences how the board functions and affects strategic decision-making quality. A relational governance perspective is used because the social ties are strong in family firms, providing potential for social control. Drawing on social capital theory, the relational governance model addresses different forms of social capital embedded in social relationships. The relational governance model argues that social interaction is a key factor influencing the formation of a shared vision and trust; these in turn, improve the strategic decision-making quality. The model also posits that social interaction within the owner family can be increased by establishing various family institutions. Decision quality and decision commitment are used as dependent variables in the models. Constructs related to both contractual and relational governance are employed as independent and mediating variables. Links between decision-making quality and overall firm performance are tested in a third model.

The hypotheses are tested using mail survey data from 192 family firms in Finland. The study uses confirmatory factor analysis to validate the constructs and multiple regression analysis to test the hypothesized relationships. For multi-item constructs, previously validated operationalizations are used whenever possible. The validity and reliability of the constructs are further checked using secondary proxies obtained through telephone interviews. The hypotheses on governance mechanisms, as well as those on the influence of these on decision-making quality, are mostly supported in the empirical analyses. Also, the results suggest that contractual and relational governance mechanisms are complementary rather than mutually exclusive. Hypotheses on the relationship between the decision-making quality variables and the overall family firm performance received partial support. This dissertation contributes to the understanding of how family firms are governed and of the impacts of various governance mechanisms on family firm performance. The results of the dissertation support the claim in the extant literature that family firms need to address the governance of the family in addition to the governance of the business. The dissertation proposes relevant practical implications for family firm owners and executives, and suggests directions for future research.

Keywords: family business, corporate governance, agency theory, social capital, strategic decision making

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Lahti, June 2002

Mikko A Mustakallio

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1 INTRODUCTION

1.1 Background

This dissertation sets out to study family firm governance, addressing the relationship between the owners and management of family businesses. Family businesses constitute a wide spectrum of enterprises, from small family-owned and managed companies to large internationally operating family-controlled corporations. A firm can be regarded as a family business if a given family holds the voting control of the firm (Neubauer & Lank, 1998).

Regardless of many differences, family businesses share some common characteristics, largely due to the interacting and overlapping domains of family, ownership and management (Tagiuri & Davis, 1982). Family firms have a complex stakeholder structure that involves family members, top management, and a board of directors. Family members, who are often significant owners, usually play multiple roles in managing and governing the firm (Tagiuri & Davis, 1982). This involvement promotes loyalty and also commitment to long-term value creation (Dyer & Handler, 1994) and reduces problems that arise from separation of ownership and control, as experienced in large, public corporations (Jensen, 1989).

Also, family businesses may enjoy a competitive advantage due, for example, to remaining entrepreneurial in character and having a strong sense of responsibility to society (Neubauer & Lank, 1998), fast verbal and nonverbal communication, aided by a shared identity and common language of families (Gersick, Davis, McCollom Hampton & Landsberg, 1997), family members' business expertise gained during early childhood onward (Kets De Vries, 1996), and a strong organizational culture contributing to external adaptation and internal integration (Schein, 1983).

However, the family's involvement in governing the firm may induce a focus on business and non-business goals, possibly leading to inefficiency (Schulze, Lubatkin, Dino & Buchholtz, 2001). If the owner family is not regularly informed about the company's affairs, differing visions of the company's future may develop between management and the family. The resulting feuds between family factions may distract management's attention from value-creating activities and so reduce their commitment to strategic decisions. Owner-managers also may act opportunistically by satisfying their own needs at the expense of the company's performance and long-term survival. Entrenched owner-managers may not share their powers with others, especially not with the company's board.

Moreover, the survival of family firms is often challenged by autocratic rule, resistance to change, lack of professionalism in management capabilities, confusion in family and business roles, rivalry and enlarged human emotions among family members, conflicts between interests of the family and the business, and a low rate of investment in business development (Donnelley, 1964; Gersick et al., 1997; Kets De Vries, 1993).

Given the many challenges family businesses face, they are rather short-lived, although some of them have been able to survive for a long time. Approximately three out ten family businesses survive into a second generation and one out of ten to a third generation (Kets De Vries, 1996). Neubauer & Lank (1998) estimate that 66-75% of family businesses are sold out or ceased during the founding generation's tenure and 5-15% continue in the control of the third generation of the founding family. The average life expectancy of a family business in the United States is twenty-four years, which is, coincidentally, the same as the average tenure of the founder (Beckhard & Dyer, 1983).

Contrary to the somewhat common belief, family firms form an important sector of economic life. According to one estime, 70-95% of all registered companies in selected European countries are family businesses (Neubauer & Lank, 1998). In a sample of 1132 small- and medium-sized companies in eight European countries, 66% were found to be family businesses (Donckels & Fröhlich, 1991). Depending on how family businesses are defined, one study suggests that 19-92% of all businesses in the United States are family businesses, that they employ 15-59% of the total work force, that they create 19-72% of new jobs, and that their contribution to the gross domestic product is 12-49% (Shanker & Astrachan, 1996). Family businesses are the predominant form of enterprise in many other areas in the world as well, in the East Asia, for example (Chau, 1991).

Considering the large economic impact of family businesses and their distinctive characteristics, it seems important to study how family firms are governed in terms of relationships among the owners and managers. Generally, a firm's ownership plays an important role in determining its governance structure (Gomez-Mejia, Nuñez-Nickel & Gutierrez, 2001), which influences its strategic decision making process (Judge & Zeithaml, 1992; Pearce & Zahra, 1991). This is especially the case in family businesses where owners may also be managers who lead the development and execution of their companies' strategies. The unique ownership structure and interpersonal dynamics that pervade family firms make them an interesting setting in which to study the contributions of ownership for these firms' governance and strategic decision making.

Yet, little family business research has focused on family firm governance (Neubauer & Lank, 1998; Dyer & Sánchez, 1998) and how family control affects firm performance (Lansberg, Perrow & Rogolsky, 1988; Litz, 1995). As Neubauer & Lank noted, "particularly scarce are research and writings in the area of governance in family enterprises" (1998: xv). Previous research on family business has mostly addressed the question of how to improve family relationships rather than business performance (Sharma, Chrisman & Chua, 1997), and a large part of past studies has dealt with management succession (Wortman, 1994).

The lack of research on family firm governance is surprising because literature provides plenty of anecdotal evidence of governance challenges in family businesses, dating back to Levinson (1971). Lansberg (1999) has claimed that most family companies are under governed, and that family firm governance should address both 'family governance' and 'business governance'. Also, mainstream corporate governance research may not directly apply to family enterprises because it deals mostly with diffusely-owned, large corporations where shareholders and management do not generally interact, and where the relationship is 'contractual'. This means that the formation and functioning of contracts describe to a large extent the nature of the relationships between different agents.

This dissertation argues that, given the duality of the economic and non-economic goals family firms pursue (Danes, Zuiker, Kean & Arbuthnot, 1999), and the complexity of the stakeholder structures, family firms need a governance structure that matches the complexity of their constituent stakeholders. Accordingly, a better theoretical and empirical understanding as to how family firms are governed is needed; the performance implications that come to light through this better understanding also need to be researched. As yet, it is not clear how governance, strategic decision-making, and performance are related within family firms, or how family firms should be governed for long-term value creation.

Several researchers have claimed that describing governance relationships only in terms of contracts among the parties is not sufficient, but that the social context and 'relational' aspects of the relationships among the contracting parties need to be addressed also (Granovetter, 1985; Macaulay, 1963; Macneil, 1980; Ring & Van de Ven, 1992). Accordingly, the view taken in the present study is that, in addition to management supervision and control, family firms need to develop relational governance mechanisms that reduce harmful conflict and promote cohesion within the family. This study follows Huse (1993; 1994) in using the dual approach of applying neoclassical economics to organizations as well as social theories of relationships for the purpose of studying corporate governance. Huse applied both socio-economic (Macneil, 1980) and agency theoretic approaches to study the relationship between board of directors and management.

This dissertation aims to make three contributions to research on family business and corporate governance. First, it addresses the lack of previous research on the governance of family firms. As noted, past corporate governance research has investigated mostly contract-based systems ignoring the potential influence of relational governance. The present study seeks to expand agency theory driven corporate governance by incorporating elements from social capital theory and literature on relational governance. By analyzing relational governance within family firms, the dissertation offers a more comprehensive analysis of governance systems.

Second, this dissertation contributes toward the understanding of how contractual and relational governance systems affect the quality of strategic decision making (Dooley & Fryxell, 1999) in family firms. Little is known about strategic decision making processes in family firms (Sharma et al., 1997). This study also responds to Harris, Martinez & Ward's (1994) call for research on ownership and strategy formulation and implementation in family firms. This research can improve the appreciation of the roles of family institutions, an area that has been identified as requiring attention (Lansberg, 1999).

Third, the dissertation uses data from Finnish family firms. Most governance research has used data from Fortune 500 corporations, or from US and British firms (Dalton, Johnson & Ellstrand, 1999; Gomez-Mejia et al., 2001). Research employing data from other countries is necessary. Studying Finnish family firms helps address this gap. The Scandinavian business culture usually depicts a more 'relational' emphasis and smaller power distances than the more 'transaction-oriented' Anglo-Saxon business cultures (Hofstede, 1997).

1.2 Research questions

There is a limited understanding, both in corporate governance literature and family business literature, about how family firms are governed. Literature on corporate governance has mainly focused on the external and internal control of "open corporations," i.e. corporations that are large, and that the shares of which are diffusely-owned and can be traded without restrictions on a stock market (Fama & Jensen, 1983a). The governance context of open corporations reflects the managerialistic view of corporations that emphasizes the role of professional, hired management in running the business according to industry and capital market standards (Johannisson & Huse, 2000). In the managerial context, the owners are not required to have any role in the corporation other than that of providing equity capital and bearing the associated financial risk. This "separation of ownership from control" leads to a divergence of interests between the shareholders and management (Berle & Means, 1932). In the light of this "managerial context," family firms seem an anomaly because they violate almost all of the assumptions held in the mainstream corporate governance literature. For example, in family firms, ownership and management are overlapped to a varying degree, the number of owners is small, and the shares cannot be easily traded.

On the other hand, extant family business literature has recognized many distinctive governance challenges that family firms face due to their complex stakeholder structure. Yet, empirical research on the governance of family businesses is scant. This dissertation aims at contributing to the knowledge of family firm governance by applying ideas and concepts from the broader governance literature to a family business context. The overall research question of the dissertation is: *What are the impacts of the governance* *mechanisms on the performance of family firms?* This overall research question is approached by addressing several more specific research questions.

The approach taken in this study is to use outcomes of strategic decision-making processes as measures of family firm performance. Family business literature provides many examples of how effective decision-making processes can be disturbed and so lead to poor organizational performance (e.g., Levinson, 1971). A firm's long-term performance and survival are vitally influenced by the quality of strategic decisions and stakeholders' commitment to their implementation (Dooley & Fryxell, 1999). Therefore, decision quality and decision commitment, which are collectively regarded in this study defining strategic decision-making quality, are selected as the main measures of the family firm performance.

Corporate governance literature addresses potential governance problems due to almost the complete separation of owners' risk bearing and managerial decision functions experienced in large, publicly held corporations. Although family firms are generally different from these corporations, separation of ownership from managerial control does also occur in family firms. The separation may grow as the family or the firm becomes larger (e.g., Gersick et al., 1997). Thus, it may be possible that family firms face similar agency problems, i.e. problems induced by different interests between the owners and managers, as large, publicly held corporations. Consequently, family firms may employ contractual governance mechanisms that minimize managerial opportunism, mirroring the prescriptions of agency theory. Contractual governance addresses aspects of the formal control exercised by the boards of directors.

Research question 1a: What are the key mechanisms of contractual governance in family firms?

Research question 1b: How does contractual governance affect the strategic decision-making quality of family firms?

Analyzing relationships among the owners and management from only a contractual perspective would be unlikely to provide a sufficient understanding of family firm governance, because the social ties are strong in family firms. Strong ties are formed as a result of a complex and self-reinforcing web of social relationships in which the key agents may operate in multiple roles as managers, owners, or family members. The enduring bonds that tie family members may also motivate participants in the governance systems to maximize the welfare of others, rather than pursuing their own individual interests. Building cohesion among the various stakeholders calls for the implementation of relational governance mechanisms that enhance the different forms of social capital embedded in social relationships (Granovetter, 1985). Relational governance is predicated on open communications and frequent exchanges that foster solidarity among family members and reduce opportunism and self-interest (Dyer & Singh, 1998). Relational governance is likely to address a number of social control mechanisms that regulate relationships among the owner family members and management.

Research question 2a: What are the key mechanisms of relational governance in family firms?

Research question 2b: How does relational governance affect the strategic decision-making quality of family firms?

Two aspects of strategic decision-making quality are used as the main measures of family firm performance. This implies an assumption that a high quality of strategic decision making has a positive effect on a family firm's overall performance. Although one of the fundamental questions in strategy research is why some firms are more successful than others (Rumelt, Schendel & Teece, 1995), past empirical research has not been able to demonstrate clearly how strategy process and firm performance are linked (Dean & Sharfman, 1996; Janis, 1989). Studying organizational performance is problematic because there are so many possible ways to define performance and because of the complexity of the causal structure of performance (March & Sutton, 1997). Further, it is questionable whether a firm's performance can be analyzed without taking into account its distinctive set of goals (Sanchez & Heene, 1997). To contribute to this discussion, the present dissertation addresses links between the overall performance of family firms and related aspects of strategic decision-making processes.

Research question 3: What are the impacts of strategic decision-making quality on the overall performance of family firms?

1.3 Objectives of the dissertation

The overall objectives of this dissertation are to chart distinctive challenges of family firm governance and to identify mechanisms through which family firms are governed. The study addresses the following topics in particular: contractual and relational aspects of governance, effects governance mechanisms on strategic decision-making quality, and the association between decision-making quality and overall firm performance. The detailed objectives that guide the research process are

- to review and analyze relevant theoretical, and other, streams of literature that focus on corporate governance, strategic decision-making, and family business
- to conceptualize the key factors relating to contractual governance and relational governance, so as to reflect aspects of both formal control and social control
- to develop a set of empirically testable hypotheses linking factors relating to governance, strategic decision-making quality, and overall firm performance
- to empirically test the hypotheses by operationalizing the theoretical constructs, identifying a suitable sample, designing the research instrument, collecting data, and testing the hypotheses using suitable quantitative methods
- to assess the significance, reliability, and validity of the results; to discuss the theoretical, empirical, and practical implications of the findings; to assess the limitations of the study, and to present suggestions for future research

1.4 Scope of the dissertation

The present study addresses the governance of family firms, focusing on the nature of various governance mechanisms and how they affect firm performance. Family businesses provide a fruitful research context to study corporate governance due to lack of governance research in the area and the distinctive characteristics of family firms. The family business context, especially, enables the study of how aspects of formal and social control vary according to characteristics of ownership structure.

The analysis of this study is set at firm level, addressing effects of governance a firm's performance. The analysis covers a set of related issues, including the ownership structure, relationships among the owner family members, board of directors, and top management and the strategic and overall performance of the family firm. By addressing how governance influences strategic decision-making quality, this study also contributes to emerging research on the interaction between corporate governance and strategic management (Baysinger & Hoskisson, 1990).

Family businesses have been defined in numerous different ways in past research, depending on the research problem under study. For example, family businesses have been defined in terms of ownership (e.g., Barnes & Hershon, 1976), generational transfer (e.g., Ward, 1987), and family members' participation in management (e.g., Litz, 1995). This dissertation adopts a broad definition of family business, taking the family's voting control of the firm as the defining element. This approach allows larger variation of the key variables in the research models. Governance challenges are likely to be very different in a family firm managed by the first generation owner-manager from those in a family firm controlled, for example, by a third generation extended family (e.g., Lansberg, 1999). The study is limited to family firms that are corporations, because these have boards of directors required by law. The board of directors is often a central governance body in family corporations.

The empirical study is geographically limited to Finland. All the provinces of mainland Finland are covered; only the Swedish speaking Åland Islands are not part of the study. A single country analysis allows control for country-specific influences. A wide range of industries is represented, including production-, trading-, and service-related businesses. The companies in this study are six years old or more, representing firms with established governance structures.

1.5 Research approaches and methods

Research approaches can generally be categorized as nomothetic or idiographic (e.g., Dooley, 1995). Research following a nomothetic approach aims at developing general laws or properties and using them in a variety of settings in the real world, while research based on an idiographic approach studies the particulars of an individual research object. The present study adopts a nomothetic approach, because it allows rigorous empirical testing of hypotheses with a large number of firms. However, developing general laws in organizational studies, or, more generally, in social sciences, may not be possible because quantitative testing can only reveal statistical associations among variables, not causal laws.

This study is divided into two major parts: theory development and theory testing. The theory is presented in the form of theoretical models describing the constructs and their hypothesized relationships. Derivation of the theoretical models is based on extant theoretical and empirical literature related to the research problem of the present study.

The main theoretical frameworks used in the study are agency theory and social capital theory. The agency theory helps to explain why different forms of organizations behave as they do and also it helps to develop refutable propositions that can be empirically tested. The positive theory of agency addresses contracting problems between self-interested, maximizing parties and uses the agency costs minimizing tautology (Jensen, 1983). The agency theory provides insights to the very different functions of ownership and management.

The quality of relationships can be a source of mutual benefit between contracting parties. A growing stream of literature, collectively called social capital theory, and a related approach known as the relational view (Dyer & Singh, 1998), provides a framework to assist our understanding of how networks of relationships contribute to organizational advantage (Nahapiet & Ghoshal, 1998). In addition to these main theoretical frameworks, the present study is influenced by many other streams of literature, most notably by family business, corporate governance, and strategic management literature.

The hypotheses are empirically tested by using quantitative statistical methods. Multiple regression analyses are employed to study whether the hypothesized relationships among the constructs are supported by the data. The quantitative data for statistical testing of the hypotheses are collected via a mail survey. This allows the collection of a large amount of data to be completed cost efficiently and in a relatively short time. In this study, the data obtained via the mail survey is cross-sectional in nature; this means that the data are collected at one point in time.

The reliability and validity of the results are carefully assessed throughout the empirical testing. The quantitative mail survey has its potential problems, including difficulties in operationalizing the theoretical constructs, low response rates and the resulting possibility of non-response bias, and respondent-related threats to reliability of the data (Babbie, 1990). A number of measures are taken to improve the quality of the data. The survey instrument is pre-tested and previously validated operationalizations are used whenever available. Otherwise, new measures based on the received theory are developed. All multi-item measures are confirmed by using factor analysis and by assessing their reliability. Possible non-response bias is assessed statistically. To further check the reliability of the survey data, additional telephone interviews are conducted in randomly selected respondent firms, consisting of two interviews in each company with respondents other than the original respondent.

1.6 Structure of the dissertation

This introductory chapter is designed to guide the research process by setting forth the research problem, defining the objectives and scope of the study, and discussing the selection of the research approaches and methods. Figure 1.1 illustrates the structure of the dissertation by showing the main phases of the research.

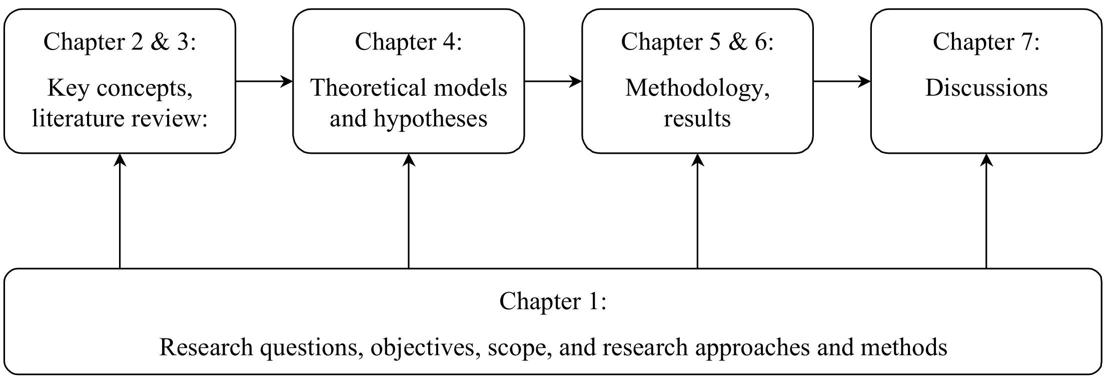

Figure 1.1 Structure of the dissertation

Chapters 2 and 3 review extant literature. Chapter 2 discusses the key underlying concepts of the study. Chapter 3 presents the literature review with an assessment of different theoretical frameworks in the light of the research problem. Chapter 4 represents the theory development phase of the study, developing theoretical models and related hypotheses. Chapters 5 and 6 form the theory-testing phase of the dissertation. Methodology employed in study is reviewed in Chapter 5, and a description of the sample and the results of the statistical analyses testing the hypotheses are presented in Chapter 6. Chapter 7 concludes the dissertation by discussing the empirical results, theoretical and practical implications, and limitations of the study, and ends by suggesting directions for further research.

2 DISCUSSION OF KEY CONCEPTS USED IN THE STUDY

This section discusses the underlying key concepts relevant to the study, including (1) ownership, corporation, and corporate governance, (2) family business, and (3) strategic decision. These concepts are not directly used as constructs in the research models of this dissertation. Rather, the key concepts described in this section provide the conceptual background, which, together with received theories, contribute to the development of the models. All the constructs that are employed in the models will be conceptualized and defined in Chapter 4, and operationalized for the empirical study in Chapter 5.

2.1 Ownership, corporation, and corporate governance

Ownership, corporation, and corporate governance are closely related concepts. Ownership of a firm's assets is usually regarded as a bundle of rights. Hansmann (1996) concisely defined a firm's owners as persons having two formal rights: "the right to control the firm and the right to appropriate the firm's profits" (1996: 11). The concepts residual risk and residual claim are important in the study of ownership and different forms of economic organization (Fama & Jensen, 1983a). The term *residual risk* refers to the difference between uncertain inflows of cash and promised payments to management, employees, and other providers of factors of production. The terms *residual claimants* or *residual risk bearers* refer to actors who have rights to these uncertain net cash flows. Alchian & Demsetz's (1972) definition of ownership of the "classical capitalist firm" addresses several rights: the right to receive the residual cash flows, the right to be the central party in writing contracts with input providers and to observe their behavior, the right to decide on the members of the management team, and the right to sell all these rights. The notion of the classical capitalist firm regards the owner as an active entrepreneur also. Jensen & Meckling (1998: 103) defined ownership as "possession of a decision right along with the right to alienate that right." The term *alienability* refers to "the right to sell a right and capture the proceeds offered in the exchange" (1998: 103). Summarizing the above points, the ownership of a firm involves three elements: (1) the right to control the firm, (2) rights to residual claims, and (3) the right to sell the ownership rights. The characteristics of the ownership rights are dependent upon the legal form of the organization.

There are many different forms of economic organizations, including, for example, proprietorships, partnerships, and corporations. Different organizational forms vary in terms of, amongst others, the characteristics of residual claims and how the owners participate in decision processes (Fama & Jensen, 1985). The corporation is a well-established organizational form; it is used from small, privately-held companies to large, diffusely-owned corporations. Common to all corporations is the general limitation of the owners' liability to the amount of common stock they have, and the fact that a corporation is a legal entity of its own, represented by individuals such as a chief executive officer (Monks & Minow, 1996). Fama & Jensen (1983a) divided corporations into *open corporations* and *closed corporations*. In the open corporation, the common stock residual claims are freely alienable and they are rights in net cash flows for the whole lifetime of the organization. Also, the stockholders do not need to have any other role in the corporation. Large companies are typically open corporations having specialized ownership and management roles. Closed corporations are usually smaller companies that are likely to have restrictions on the alienability of the common stock. Both open and closed corporations can survive, but on the basis of a different set of advantages and disadvantages (Fama & Jensen, 1983a). This dissertation posits that a family firm can fall anywhere between open and closed forms of corporations, depending on the extent to which owners participate in managing the business, and how easily the shares can be traded in capital markets.

Organizational economics, especially the agency theory, views a corporation as *a nexus of contracts* (Alchian & Demsetz, 1972; Jensen & Meckling, 1976). In this view, the corporation serves as a focal point in coordinating a set of contracts, both implicit and explicit, with creditors, suppliers, customers and all other exchange partners. The corporation is seen as a "legal fiction," behaving much like a market in bringing conflicting objectives of individuals into equilibrium (Jensen & Meckling, 1976).

Development of corporate governance has largely been induced by the "separation of ownership from control" in large corporations (Berle & Means, 1932). There is no clear definition of what corporate governance actually means. This is illustrated by the following examples. Monks & Minow (1996: xvii) defined corporate governance as "the relationship among various participants in determining the direction and performance of corporations." The key participants in this definition are the shareholders, the management, and the board of directors. According to Demb & Neubauer, corporate governance "is the process by which corporations are made responsive to the rights and wishes of stakeholders" (1992: 187). In their book devoted to family business governance, Neubauer & Lank defined corporate governance as "a system of structures and processes to direct and control corporations and to account for them" (1998: 60). Johnson & Sholes (1999: 203) argued that "governance framework determines whom the organization is there to serve and how the purposes and priorities of the organization should be decided."

The most common view is that corporate governance addresses the relationship among the owners and the management (e.g., Monks and Minow, 1996). The central question in corporate governance is how this relationship influences strategy formulation, decision-making, value creation and value distribution (Jensen, Baker, Baldwin & Wruck, 1996). The present study adopts this owner-manager relationship-centered view of corporate governance, because it focuses on relationships among owners, family members, and managers. This view does not refute the need to be responsive to all stakeholders of the company (e.g., Donaldson & Preston, 1995).

2.2 Family business

There is no common agreement as to what the term *family business* actually means. This is probably due to multiple research approaches adopted in past research and the rather short time research in this area has been conducted. The wide scope of family businesses ranging from small shops to large family-controlled corporations contributes to the definitional confusion (Handler, 1989a).

Table 1 provides a representative sample of definitions published in scholarly journals and books. In the table, eight definitions explicitly refer to family ownership or ownership control, six refer to family involvement in the company's management, five address multiple generations or generational transfer, four refer to family participation in the company's goal setting and other strategic decision making, two address the family's intention or vision of continuing the business as a family business, one addresses family goals, and one the interaction between the family and business systems.

The definitions imply six themes for clarifying the boundaries of the domain of family business: (1) ownership, (2) management, (3) generational transfer, (4) the family's intention to continue as a family business, (5) family goals, and (6) interaction between the family and business. These themes are similar to those found in the extant literature. For example, Handler (1989a) categorized family business definitions under four headings: ownership and management, interdependent subsystems, generational transfer, and multiple conditions.

Table 2.1 *Family business definitions*

"a company is considered a family business when it has been closely identified with at least two generations of a family and when this link has had a mutual influence on company policy and on the interests and objectives of the family" (Donnelley, [1964] 1988: 428).
"controlling ownership rested in the hands of an individual or of the members of a single family" (Barnes & Hershon, 1976: 106).
"Organizations where one or more extended family members influence the direction of the business through the exercise on kinship ties, management roles, or ownership rights" (Tagiuri & Davis, [1982] 1996: 199).
"It is the interaction between the two sets of organization, family and business, that establishes the basic character of the family business and defines its uniqueness" (Davis, 1983: 47).
"What is usually meant by 'family business'...is either the occurrence or the anticipation that a younger family member has or will assume control of the business from an elder" (Churchill & Hatten, 1987: 52).
"We define a family business as one that will be passed on for the family's next generation to manage and control" (Ward, 1987: 252).
"A business in which the members of a family have legal control over ownership" (Lansberg et al., 1988: 2).
"A family business is defined here as an organization whose major operating decisions and plans for leadership succession are influenced by family members serving in management or on the board" (Handler, 1989b: 262).
"firms in which one family holds the majority of the shares and controls management" (Donckels & Fröhlich, 1991: 149).
"A business where a single family owns the majority of stock and has total control. Family members also form part of the management and make the most important decisions concerning the business" (Gallo & Sveen, 1991: 181).
"A business firm may be considered a family business to the extent that its ownership and management are concentrated within a family unit, and to the extent its members strive to achieve, maintain, and/or increase intraorganizational family-based relatedness" (Litz, 1995: 78).
"A business governed and/or managed on a sustainable, potentially cross-generational, basis to shape and perhaps pursue the formal or implicit vision of the business held by members of the same family or a small number of families" (Sharma et al., 1997: 2).
"A family enterprise is a proprietorship, partnership, corporation or any form of business association where the voting control is in the hands of a given family" (Neubauer & Lank, 1998: 8).

Some definitions are more inclusive. For example, Gallo & Sveen's (1991) definition includes mention of majority ownership, total control, participation in management, and strategic decision making. Some other definitions are less inclusive, for example, the definition of Barnes & Hershon (1976) addresses only the controlling ownership.

The present study does not categorize companies into family businesses and non-family businesses by applying some strict definition. Instead, some dimensions are treated as variables in the models presented in this study, most notably ownership structure and family size. For the purposes of the present dissertation, the family business is defined broadly as "a proprietorship, partnership, corporation or any form of business association where voting control is in the hands of a given family." (Neubauer & Lank 1998: 21). More specifically, the voting control is defined here as "the power to exercise discretion over major decision making, including specifically the choice of directors" (Leech & Leahy, 1991: 1418). The terms *family business* and *family firm* are used interchangeably in this study.

The extant literature on family business research has largely neglected the definition of the family itself. By modifying Winter's, Fitzgerald, Heck, Haynes & Danes (1998) definition of the family, the present study defines it as a kinship group of people related by blood or marriage or comparable relationship. This definition allows a multi-generational view of an extended family.

2.3 Strategic decision

Only a few decisions made in a company can be termed "strategic." Although it is difficult to make a well-defined distinction between the strategic and non-strategic decision, some distinctive characteristics have been proposed in the literature. Mintzberg, Raisinghani & Theoret defined the term *decision* as "a specific commitment to action (usually a commitment to resources)," the term *strategic* as "important, in terms of the actions taken, the resources committed, or the precedents set," and the term *decision process* as "a set actions and dynamic factors that begins with identification of stimulus for action and ends with the specific commitment to action" (1976: 246). Chandler defined strategic and tactical decisions as follows: *"Strategic* decisions are concerned with long-term health of the enterprise. *Tactical* decisions deal more with day-to-day activities necessary for efficient and smooth operations. But decisions, either tactical or strategic, usually require implementation by an allocation or reallocation of resources-funds, equipment, or personnel" (1962: 11). Following Mintzberg et al. (1976), Nutt defined a strategic decision as "a choice with important consequences and resource demands for the organization" (1998: 198). The above definitions capture the essential elements of a strategic decision, including a long-term view, decision as a choice, resource commitment, and important consequences. The present study adopts Nutt's (1998) definition of the strategic decision, because it captures the essence of the concept and explicitly recognizes the notion of choice implying that there are alternative courses of action.

The term "strategic choice" (Child, 1972) is occasionally used in this study. Strategic choice is similar to the concept of strategic decision, yet having some differences of nuance. The term strategic choice is commonly used in situations where the top management team as a decision agent is of interest. Hambrick & Mason noted that the term strategic choice "is intended to be a fairly comprehensive term to include choices made formally and informally, indecision as well as decision, major administrative choices...as well the domain and competitive choices more generally associated with the term 'strategy'" (1984: 195). This definition implies that in addition to competitive strategy, the strategic choice concept encompasses issues often included in the notion of organizational strategy. This study uses the terms strategic decision and strategic choice interchangeably.

In addition to defining strategic decisions in terms of their importance to organizations, they can be characterized on the basis of their cognitive features. Typically, strategic decisions are described as poorly structured, complex, ambiguous, unique, and non-routine. Schweiger, Sandberg & Ragan (1986) described strategic problems as "wicked" because they address complicated links between the organization and environment, uncertain and dynamic environments, ambiguity of information, and conflicts between interested parties.

3 LITERATURE REVIEW

This chapter reviews extant research literature relevant to the research problem of family firm governance. First, the practical and theoretical aspects of corporate governance are reviewed on a general level, and then the two theoretical governance frameworks of this dissertation are selected. Next, these two theoretical frameworks, the agency theory and the social capital theory, are discussed in more detail. Then the literature on strategic decision making and on family business is reviewed. The chapter concludes by addressing the distinctive challenge of family firm governance, and by comparing the theoretical frameworks and assessing their applicability to the study of family firm-governance.

3.1 Corporate governance and selection of theoretical frameworks

3.1.1 Introduction to the central theme in corporate governance

The central theme in corporate governance was laid out by Berle & Means. They noted that "[t]he separation of ownership from control produces a condition where the interests of the owner and of ultimate manager may, and often do, diverge" ([1932] 1997: 7). In the modern corporation, ownership is dispersed among numerous individuals and decision making is taken care of by hired, professional management. This allows a concentration of power in the hands of management who may advance their own interests at the cost of the owners' interests. Consequently, the owners are left in a weak position compared to management. Berle & Means are not the first authors to recognize the potential problems of the separation of ownership and management control, but it is they who brought the issue under systematic study. It is noteworthy that, Adam Smith ([1776] 1937), the first of the great classic economic theorists, noted that "the directors of such [joint-stock] companies, however, being the managers rather of other people's money than of their own, it cannot be well expected, that they should watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch their own. Like the stewards of a rich man, they are apt to consider attention to small matters as not for their master's honour, and very easily give themselves a dispensation from having it. Negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company" (quoted in Jensen, 2000: 83).

The separation of ownership from control has been made possible by the emergence of the joint stock company, i.e. the modern corporation. According to Collin (1995), the corporate form of organization has evolved during three periods: the first industrial revolution from about 1600 to 1870, the second industrial revolution from 1870 to 1930, and the period following the Second World War. Among the first applications of the corporate form of company were British and Dutch joint stock trading companies (Berle & Means, ([1932] 1997), which typically took part in risky oversees exploration and shipping operations. The second phase is marked by an expansion of corporations and the creation of some giant enterprises. Business historian Alfred Chandler (1962) has written a widely referred to book about how these corporations operated. The third phase, i.e. the period following the Second World War, is covered by a large body of governance and management literature (e.g., Galbraith, 1972; Jensen, 1993).

To a large extent, corporate governance literature deals with the various ways of increasing the owners' position against potential malfeasance of top management (Brancato, 1997; Monks & Minow, 1996). Corporate governance literature addresses extensively how to protect the shareholders' interests by employing various external and internal governance mechanisms (Walsh & Seward, 1990). Although corporate governance may address the interests of any stakeholder group of a company, it has traditionally studied relationships among the owners and company's top management. The main actors in corporate governance literature are typically the owners, board of directors, and top management (Monks & Minow, 1996). The degree of dispersion of ownership varies from closely held corporations where owners are often key managers, to very widely held corporations where individual owners have only a small fraction of the common stock. The modes of corporate governance vary greatly between these various kinds of organizational forms (Fama & Jensen, 1983b).

Corporate governance is influenced by institutional factors also. For example, the legal system defines property rights and sets boundaries within which the companies must operate (Shleifer & Vishny, 1997). Also, the efficiency of capital markets directly influences how corporate governance is shaped in different countries (Kaplan, 1997). Lubatkin, Lane, Collin & Very (1999) proposed that corporate governance is nationally bounded because of different national demographics, histories, values and norms, and formal institutions.

3.1.2 Theoretical frameworks related to corporate governance

Agency theory has emerged as the dominant theoretical framework used in corporate governance because it can provide plausible explanations useful to the study of the separation of ownership from control (Collin, 1995; Eisenhardt, 1989a; Zahra & Pearce, 1989). Agency theory is based on neoclassical economics, it directly studies the relationship between owners and management, it assumes limited rationality and self-interested behavior of human beings, and it predicts behavioral consequences in numerous "agency" relationships and situations (e.g., Milgrom & Roberts, 1992). Agency theory will be discussed separately in Chapter 3, Section 2. In addition to agency theory, there are other theoretical approaches that have been applied in corporate governance or interorganizational governance, to a varying degree of explicitness. Table 3.1 shows six theoretical frameworks that may be used in corporate governance or in the governance of interorganizational relationships.

Table 3.1 Theoretical frameworks used in governance

Theoretical Frameworks	Basic approach	Applications in governance
Agency theory	Minimization of problems caused by the separation of ownership from control	Relationships between principal and agent, usually among owners and management
Transactions cost economics	Selecting governance structures that minimize transaction costs	Vertical integration, strategic alliances, acquisitions
Evolutionary approaches	Population, organization, and intraorganizational level conditions and outcomes of evolutionary processes	Influencing the variation, selection, and retention processes to increase the likelihood of firm survival
Resource-based view	A firm is seen as bundle of tangible and intangible resources rather than as a product-market position	Resource leverage and complementary resources in interfirm relations
Resource dependence Theory	Political approach to manage interdependencies between organizations	Networks, interfirm, intrafirm governance
Social capital theory	Socially constructed reality creates resources embedded in relationships	Network and interorganizational relationship governance

Transaction cost economics (Coase, 1937; Williamson, 1975; 1985) attempts to specify optimal boundaries of a firm's activities by taking into account the "transaction costs" caused by dealing with other organizations. Initially, the analysis focused on whether to source a good or service externally by an arm's length market transaction or to produce it within the hierarchy of a firm. Because of increasing interorganizational cooperation, transaction cost economics has begun to address intermediate forms of organizations used in strategic alliances, partnerships, coalitions, franchises, and various forms of network organizations (Ring & Van de Ven, 1992). Concentrating solely on the costs, transaction cost economics has been criticized in not addressing the value creation aspect of interorganizational cooperation (Ghoshal & Moran, 1996). Although transaction cost economics is the dominant theoretical framework in interfirm governance (Keil, 2000), its use in corporate governance is rare.

Evolutionary approaches (Aldrich, 1999; Nelson & Winter, 1982) form a set of theories looking at the development of nations, industries, and companies over time in a dynamic and multi-level fashion. Hannan & Freeman (1989) argued that at a company population level, the survival of organizations is mostly determined by impersonal forces. At a company level, evolutionary approaches give more room to managerial choice in determining organizational survival. For example, the adaptive value of a company's strategy can be increased by promoting "autonomous" strategy processes (Burgelman, 1991). One contribution of evolutionary approaches to governance and management of companies is that evolution is not a static process and that company development is path dependent, i.e. history matters. A review of the literature shows that evolutionary approaches are not explicitly used as a theoretical framework in corporate governance, although the evolutionary perspective is consistent with it. Jensen (1983) noted that understanding a firm's survival process involves understanding how low-cost control of agency problems is achieved.

The resource-based view sees the firm as a bundle of tangible and intangible resources (Penrose, 1959; Wernerfelt, 1984). A firm's resources can be the basis of sustained competitive advantage if the resources are valuable, rare, imperfectly imitable, and not substitutable (Barney, 1991). According to the resource-based view, a firm's strategy should be driven by exploiting existing resources and by developing new ones. This view is opposed to the industrial organization view that maintains that the basis of competitive advantage is understanding the forces of competition in the firm's industry, and in building a strong position in it (e.g., Porter, 1980). The dynamic capabilities approach builds on the resource-based view and offers a more dynamic view to competitive advantage. "Dynamic capabilities" refers to a firm's ability to integrate, build, and reconfigure internal and external competences to address changing environments (Teece, Pisano & Shuen, 1997). In the area of governance, the resource-based view of the firm has been applied in interfirm relationships (e.g., Eisenhardt & Schoonhoven, 1996). Habbershon & Williams (1999) introduced a resource-based framework for studying family firms. In this kind of framework, the notion of "familiness" refers to family business resources arising from the interaction between the business, family, and its individual members.

Resource dependence theory focuses on those strategic actions of organizations that are intended to influence and control interdependencies with other organizations in their environment. The need to manage interdependencies is ultimately induced by the resource-scarcity of organizations; they cannot produce all the resources they need, and, consequently, they depend on resources offered by other parties. The resource dependence theory is influenced by earlier studies of interorganizational exchanges that emphasized the social aspects of exchange relationships (e.g., Levine & White, 1961; Blau, 1964). For example, beyond pure economic considerations, the reciprocal nature of a series of transactions between exchange partners was addressed. Central to the resource dependence theory is the proposition that power and dependence are tightly related. Party A is dependent on party B to the extent that party A cannot manage without the resources controlled by party B while party A is unable to obtain them elsewhere (Emerson, 1962). This resource dependence can lead to an asymmetric power relation between the parties. Firms can increase their power by reducing their dependence on other parties by either acquiring control over the resources they need or by acquiring control over the resources that the other parties need (Pfeffer, 1981). The resource dependence theory takes an active managerial approach to interorganizational relations. Behavior within those relations is explained by managerial motives to gain more autonomy and to reduce the impact of external threats (Pfeffer & Salancik, 1978). Managers seek some interdependencies and avoid some others based on the availability of power and control possibilities inherent in those interdependencies. The resource dependence approach to interorganizational relations proposes "aggressive intervention" and is the most "overtly political model” compared to the other approaches to organizational studies (Aldrich, 1999).

The sixth theoretical framework introduced in Table 3.1 represents the social capital theory. This theory is rooted in sociology and has emerged as a new approach to explain interorganizational relations. The social capital theory posits that there are valuable resources embedded in social relations (Granovetter, 1985). The social capital framework is reviewed separately in Chapter 3, Section 3.

3.1.3 Selection of the main theoretical governance frameworks used in the study

All the six theoretical frameworks briefly reviewed above have the potential to be applied in empirical studies on corporate governance of family firms. Table 3.2 indicates such potential use of the frameworks.

Table 3.2 Potential use of the theoretical frameworks in family firm governance

Theoretical frameworks	Potential application in family firm governance
Agency theory	Effects of the separation of ownership from managerial control
Transaction cost economics	Firm boundaries; ownership and financing structures
Evolutionary approaches	Factors promoting and inhibiting survival of family firms
Resource-based view	Family-related resources leading to sustained competitive advantage
Resource dependence theory	Power and resource aspects of relationships in family firms
Social capital theory	Effects of resources embedded in relationships

In this study, the agency theory and the social capital theory have been selected as the main theoretical frameworks. The effects of separation of ownership and control on family firm governance and decision making are an essential part of the research problem. This motivates the use of the agency theory. Family businesses are rich in relationships. Relationships between owners and management in family firms are much stronger than in large, open corporations. The social dimension of relations in family firms motivates the use of the social capital theory as the second main theoretical framework in the study.

In addition to specific consideration of family firms, the selection of the theoretical frameworks can be motivated by a more general theoretical basis. Transaction cost economics, evolutionary approaches, the resource-based view, and resource dependence theory all fall short in some theoretical respects. First, the overall purpose of this dissertation is to study how corporate governance, strategic decision making, and firm performance are related in a particular ownership context. Some frameworks may not be fully consistent with this overall purpose. Transaction cost economics addresses mainly the cost efficiency aspects of governance. By doing so, it ignores the value creation aspect of governance, which is of vital importance when analyzing strategic decision processes. The resource dependence theory may offer too political a view of the relationship between the owners and managers, thus downplaying the effects of good ongoing social relationships. Second, not all the theoretical frameworks are equally suitable concerning the unit of analysis of the study, which is generally the individual firm. For example, the resource-based view analyses how a firm's internal characteristics contribute to achieve its competitive advantage. Such characteristics address lower level organizational characteristics such as physical assets, knowledge, capabilities, and processes. Third, as the strategic choice is important to the topic of the dissertation, not all the frameworks are well suited for this purpose. Especially not evolutionary approaches, which offer rather deterministic views on a firm's strategic behaviors, without leaving much room for managerial strategic choice. However, these theoretical frameworks are not necessarily completely inconsistent with the study. Whenever feasible, these, or other theoretical frameworks, may be used in the study along with the agency theory and the social capital theory.

3.2 Agency theory

3.2.1 Introduction to agency theory

Agency theory is an economic approach that aims at explaining why and how firms behave as they do (Jensen, 1983). The notion of the relationship of agency is central in the agency theory. According to Ross "the relationship of agency is one of the oldest and commonest codified modes of social interaction. We will say that an agency relationship has arisen between two (or more) parties when one, designated as the agent, acts for, on behalf of, or representative for the other, designated the principal, in a particular domain of decision problems. Examples of agency are universal. Essentially all contractual arrangements, as between employer and employee, or the state and the governed, for example, contain important elements of agency" (1973: 134). Typically, in agency theoretical analyses, the owners of a firm are considered as "principals" and managers as "agents." Based on the agreement between the principal and agent, the agent makes choices and takes actions and, then, both parties share the consequences (Ross, 1973).

Agency theory deals with potential problems of the agency relationship and how different ways of contracting and organizing affect the outcomes of that relationship. Agency problems arise due to differences in goals, attitudes toward risk, and information asymmetries among the principals and owners. As Eisenhardt (1989a) noted, the agency theory addresses two problems that can occur in agency relationships. The first problem arises when the goals of the principal and agent conflict and when it is also difficult to verify what the agent is actually doing. The second problem deals with risk sharing when the principal and agent have different attitudes toward risk, and thus may prefer different actions. Before proceeding with the agency theory, its roots in economics are briefly discussed below.

Classical economics, and, later, neoclassical microeconomics do not offer any theory of how the firm works internally (Demsetz, 1983; 1997a; 1997b; Jensen & Meckling 1976). Neoclassical economics provides models on how the price system coordinates the use of resources in a large, decentralized commercial system. Neoclassical theory assumes that markets function freely and that prices and technology are known by all interested parties. The firm is treated like a profit maximizing "black box" transforming inputs to outputs using known technology. The outputs of firms are consumed by households who also supply resources to firms. The firm and managerial resource allocation do not play a central role in the neoclassical theory. The firm in the neoclassical theory is often likened to an entrepreneur or owner-manager, while multi-person firms are not needed in the analysis. Coordination occurs through impersonally determined prices, not by managerial planning. Owners are expected to be in effective control of their assets. Neoclassical theory does not address how the often-conflicting interests of owners and managers are brought into equilibrium. Many "theories of the firm" are actually theories of markets in which firms are important value-maximizing actors. In economics, maximizing models are not capable of explaining managerial behavior in corporations, because the firm is often treated as a "black box."

Ronald Coase's (1937) article can be regarded as the main impetus for developing various "theories of the firm." Coase was concerned with the question of why firms exist at all if resources are allocated through the price mechanism, i.e. through arms-length market transactions. Coase proposed that there are contracting costs of using the price mechanism and that these costs may be avoided if certain operations are conducted within a firm. Coase discussed many concepts that are key to modern economic theories of the firm, including the employer-employee relationship, the contractual nature of a firm's activities, and the affect uncertainty has on the existence of firms.

Three related but distinctive main branches of economic theories of the firm can be identified: transaction cost economics, property rights theory, and agency theory (Williamson, 1985). They all emphasize the contractual nature of the firm and explain the existence of firms in terms of efficiency as compared to classical market exchange. Transaction cost economics is concerned with those conditions that determine whether transactions are made in the markets or in the hierarchy of a firm (Williamson 1975; 1985). Diverse literature on the property rights emphasize the interconnectedness of ownership rights, incentives, and economic behavior (Furubotn & Pejowich, 1972). Property rights literature has implications for the agency theory. Jensen & Meckling (1976) noted that the distribution of costs and rewards among the participants in any organization is determined by the specification of individual rights. Because the specification of rights is generally affected through implicit or explicit contracting, managerial behavior will depend on the nature of these contracts.

Jensen (1983) identified two streams of literature covering the agency theory: the *positive theory of agency* and *principal-agent* literature. Both branches of the agency literature study the contracting problem between self-interested, maximizing parties and uses the agency costs minimizing approach. The principal-agent literature has concentrated on modeling the effects on contracts between principal and agent, addressing the structure of the preferences of the parties, the nature of uncertainty, and the informational structure in the environment. Attention is generally focused on the form of the optimal contract and risk sharing between principal and agent, and on welfare comparisons (e.g., Spence & Zeckhauser, 1971; Ross, 1973; Raviv, 1979; Harris & Townsend, 1981; Holmström, 1979; Shavell, 1979). Holmström (1979), for example, studied the role of imperfect information in a principal-agent relationship subject to moral hazard. In principal-agent literature, *moral hazard* refers to "lack of effort on the part of the agent," and *adverse selection* refers to "the mispresentation of ability by the agent" (Eisenhardt, 1989a: 61).

The positive agency literature has generally concentrated on modeling the effects of the means of monitoring and bonding on the form of the organizations and contracts that survive (Jensen, 1983). It also addresses additional aspects of the contracting environment, for example, capital and labor markets, the degree of specialization of assets, and capital intensity.

Principal-agent literature relies heavily on mathematics and is less empirically oriented, whereas the positive theory of the agency is less mathematically inclined and it can directly be used for developing empirically testable theories (Jensen, 1983). Jensen (1983) suggests that the two streams of agency literature are likely to become closer in the future. He also noted that the principal-agent literature could contribute to generate non-obvious testable propositions. However, some authors regard mathematical models found in the principal-agent literature not applicable to organizational studies. For example, Tosi, Katz & Gomez-Mejia noted that "mathematical models that carefully specify contract conditions and lead to deterministic solutions (e.g., Holmström, 1979) are divorced from organizational realities because of the impossibility of capturing all possible eventualities, the presence of uncertainty, lack of information, and the dynamic nature of the principal-agent relationships" (1997: 585).

The positive theory of agency takes into account many organizational contingencies, and it studies behavioral implications of different organizational forms. One of the main parameters in the positive theory of agency is the degree of separation of ownership and control, or, more precisely, separation of the residual risk-bearing functions and decision management (Jensen, 1983). Jensen & Meckling's (1976) widely referred to article on ownership structure and agency relationship can be regarded as a landmark writing in the development of the positive theory of agency. The remainder of this section reviews literature on the positive theory of agency, which is developed by Michael Jensen and his collaborators.

An important variable in Jensen & Meckling's (1976) analysis is how much of the equity is owned by inside managers and how much by outside owners. The analysis assumes that capital markets are efficient and the equity-selling owner-manager will bear agency costs incurred by monitoring. From the owner-manager's point of view the optimal share of outside financing to be obtained from equity for a given level of internal equity is that that results in minimum total agency costs. The manager's utility is maximized by the optimum mix of various pecuniary and non-pecuniary benefits. As the owner-manager's fraction of the equity falls, he tends to appropriate larger amounts of corporate resources to his own use. This causes the outside-owners to monitor the manager's activities. When the manager's share of the equity falls, his or her incentive to search new profitable opportunities also falls. If the equity market is efficient, the benefits of monitoring and bonding activities are reflected in the value of equity. Jensen & Meckling argued that agency costs are unavoidable in the agency relationship. The use of outside equity is justified if the benefits of the agency relationship are greater than the agency costs.

Contractual relations are the essence of the firm in the agency theory. Jensen & Meckling's (1976) emphasized that a firm is simply a legal fiction serving as *a nexus for contracting relationships*. The firm "behaves" like a market, and its outcomes are determined by a complex equilibrium process. According to Fama & Jensen (1983b), written and unwritten contracts, or "rules of the game," specify the rights, the performance criteria, and the payoff functions of the various agents. The central contracts in the organizations specify (1) the nature of residual claims, and (2) the decision process among agents. In addition to the "nexus of contracts view," the positive theory of agency consists of a few "fundamental building blocks" (Jensen, 1998), including the nature of human behavior, the costs of transferring information, the agency costs of co-operative behavior, and "organizational rules of the game" contributing to organizational success or failure.

Jensen & Meckling (1994) proposed a multi-faceted model for human behavior. They claimed that their model of human nature included a minimum set of characteristics that can be used to explain a wide range of social phenomena in economic organizations. The model is defined by four "postulates" suggesting that (1) every individual evaluates almost everything, and is ready for trade-offs, (2) each individual's wants are unlimited, (3) individuals are maximizers, but they are constrained in satisfying their wants, and (4) individuals are resourceful in creating new opportunities. Jensen & Meckling (1994) contrasted their model to other models of human behavior including the economic, the sociological, the psychological, and the political models. The Jensen & Meckling (1994) model of human behavior aims at incorporating some features and dismissing other features from the other models of human behavior. The economic model contributes the point that people are resourceful and self-interested maximizers. The social model contributes to the understanding how social change occurs. The psychological model recognizes that individuals have wants. The political model suggests that people have capacity for altruism. Jensen & Meckling distinguish between a perfect agent and an altruist, who behaves in a way that may be harmful to himself but beneficial to others. The perfect agent is ready to serve a variety of principals, whereas the altruist is selective about what causes to serve.

Jensen (1994) argued that self-interested and altruistic, i.e. having a concern for the well being of others, behavior are not inconsistent. People are self-interested and they have, at the same time, altruistic characteristics. For example, Jensen noted that people do help family and neighbors. Furthermore, people are not perfect agents. There is plenty of abuse in families, church, business, and government, for example. Jensen claimed that greater attention to self-interested or to rational behavior would be beneficial to everyone. Furthermore, Jensen (1994) noted that individuals do have non-rational, self-damaging features in their behavior. Non-rational behavior may random or inexplicable but it is dysfunctional behavior that harms the individual.

If parties in an agency relationship are utility maximizers then the agent will not always behave in the best interest of the principal, and agency costs will be incurred. Jensen & Meckling (1976) classified agency costs into three categories: monitoring expenditures, bonding expenditures, and residual loss. *Monitoring costs* are incurred by the principal's monitoring designed to reduce the agent's deviant activities. *Bonding costs* are created by the agent to protect the principal's interests. Monitoring involves, for example, auditing, formal control systems, budget restrictions, and incentive compensation systems.

Bonding activities include, for example, contractual limitations on the manager's decision-making power. The *residual loss* arises when the agent's decisions are not optimal from the principal's point of view.

Information processing and knowledge-related challenges contribute to forming agency relationships, which, in turn, cause agency problems. According to Jensen & Meckling (1998), individuals have limited knowledge on two levels. The first limitation is imposed by general technological feasibility reflecting the level of human knowledge of physical laws. The second limitation is specific to each individual's mental capabilities and it is often called *bounded rationality* (March & Simon, 1958). There are two means to colocate valuable knowledge and decision rights in decision making. One is to transfer knowledge to those who have the decision rights. The other is to transfer the decision rights to those who have the knowledge. The second way of colocating knowledge and decision rights has gained much less attention than the first one. Jensen & Meckling (1998) claimed that control and knowledge are complements in organizational analysis. The more specific knowledge is, the more costly it is to transfer it. Transferring knowledge is not merely communicating it, but communicating it in such a way that the message is understood well enough for it to be acted upon.

Jensen & Meckling (1998) compared how decision-making rights are assigned in markets and within firms, and the motivation of agents to make proper decisions. Specifically, the authors discuss the organizational implications of the costs of transferring information between agents. The use of specific knowledge, i.e. knowledge that is costly to transfer among agents, requires decentralizing many decision rights among agents. This decentralization leads rights assignment problem and the control problem. According to Jensen & Meckling (1998), the market system solves the rights assignment and control problems by granting alienability of decision rights to decision agents. Alienable rights are specific rights associated with ownership: the right to sell the resource and the right to capture the proceeds of the sale. The rights assignment problem is solved by colocating knowledge and decision rights through voluntary purchase and sale. Alienability solves the control problem: first, it provides a measure of performance through market prices; second, it provides the reward or punishment as a result of using alienable decision rights.

Firms are different from markets concerning the alienable decision rights because they do not generally grant both decision rights and alienability of those rights to the agent in their decision structures (Jensen & Meckling, 1998). Assignment of decision rights in firms are a matter of policy and practice instead of a voluntary exchange of alienable decision rights. Since alienable decision rights are not generally granted to agents in firms, substitute mechanisms exist. According to Jensen & Meckling (1998), organizational problems are solved by devising a set of rules that (1) partition out the decision-making rights to agents throughout the organization, and (2) create a control system that provides measures of performance and specifies the relationship between rewards and the measures of performance.

Knowledge considerations are important in explaining the survival of firms. Jensen & Meckling (1998) emphasized the importance of colocation of knowledge and decision authority. They referred to Hayek (1945) who has argued that the distribution of knowledge in society calls for decentralization. Hayek noted that "the peculiar character of the problem of a rational economic order is determined precisely by the fact that the knowledge of the circumstances of which we must make use never exists in concentrated or integrated form, but solely as dispersed bits of incomplete and frequently contradictory knowledge which all the separate individuals possess" (1945: 519) and that "if we can agree that the economic problem of society is mainly one of rapid adaptation to changes in particular circumstances of time and place...we cannot expect that this problem will be solved by first communicating all this knowledge to a central board which, after integrating *all* knowledge, issues the orders. We must solve it by some form of decentralization" (1945: 524). Hayek's argument largely refutes the usefulness of heavy centralized planning. This view is also adopted by the agency theory.

Jensen & Meckling (1998) argued that there is an optimal location of decision rights that minimizes the total organizational costs. Because of limited individual capabilities and knowledge, the chief executive cannot make personally every decision in the organization. The challenge is how to delegate the decision rights within the organization. In assigning decision rights, a second problem arises due to the self-interested nature of individuals. Individuals' objectives diverge from each other causing conflicts of interest in cooperative behavior. Conflicts of interest create agency costs, as they are commonly called. Dispersion of valuable knowledge and conflicts of interest in delegation create a trade-off challenge. Complete centralization creates high costs due to poor information whereas complete delegation creates high agency costs due to inconsistent objectives.

In the positive theory of agency, the decision process is an important factor in explaining the survival of organizations. Combination of decision control (ratifying and monitoring), decision management (initiation and implementation), and residual risk bearing usually happens in noncomplex organizations where specific knowledge important to the organization is in the hands of a few agents (Fama & Jensen, 1983b). It is common in classical entrepreneurial firms such as proprietorships, partnerships, and closed corporations where major decision agents are also the major risk bearers. Also, these organizations may have residual claimants who are not decision agents. The combination of decision control, decision management, and residual risk bearing has disadvantages due to the restricted risk sharing of assets and limited specialization of decision functions. On the other hand, most of the agency costs are avoided. Depending on circumstances, the optimal solution can be either combining or separating ownership and control.

According to Fama & Jensen (1983b), separation of decision management, decision control, and residual risk bearing is most often observable in large, complex organizations. The residual claims in those companies are diffused to numerous residual claimants who can diversify their risk (Fama & Jensen, 1983b). Decision rights tend to be delegated to agents with the best specific knowledge. This creates agency problems that are reduced by separating decision management and decision control. In open corporations, the residual claimants are not required to have any other role in the corporation, and their residual claims are freely alienable. In open corporations the decision management and residual risk bearing are separated and specialized functions. Being an expert in one area does not imply competence in the other area. The stock market functions as an external monitoring device. The stock prices summarize the expectations of current and future cash flows. The market for takeovers is made possible by the unrestricted nature of residual claims. Outside managers can try to get hold of decision control from the current board and management by a tender offer or a proxy fight.

3.2.2 Applications of agency theory

Agency theory has been applied to a wide range of studies where cooperative behavior is an issue and an agency relationship can be identified. For example, agency theory has been applied in studies addressing accounting, economics, political science, organizational behavior, sociology, marketing, compensation, acquisition and diversification strategies, board relationships, ownership and financing structures, vertical integration, and innovation (Eisenhardt, 1989a; Øyvind, 1998). Earlier empirical applications of the agency theory related to finance and accounting, including, for example, studies on the selection of accounting methods in various contexts (Holthausen, 1981; Leftwich, 1981) and wealth effects of convertible calls (Mikkelson, 1981). The degree to which the agency theory is applied in empirical studies varies greatly. Some studies use agency theory only peripherally together with other theoretical approaches, while some other studies use it as the main theoretical framework.

Studies on corporate governance have commonly applied agency theory as its main theoretical framework, probably because an agency relationship is easy to identify and where parties often have deviating interests, at least partly. Empirical research into corporate governance, explicitly using the agency theory, has studied how board of directors balance entrenchment avoidance and unity of command in situations where the same person holds both the chief executive officer and chairman positions (Finkelstein & D'Aveni, 1994), the effects of corporate control activities on internal control mechanisms and innovation (Hitt, Hoskisson, Johnson & Moesel, 1996), how ownership structure affects productivity directly as well as when mediated by diversification, research and development expenditures, and capital intensity (Hill & Snell, 1989), top management compensation and incentives (Jensen & Murphy, 1990), and the effects of internal governance mechanisms on agent decision making (Tosi et al., 1997).

Many empirical studies have addressed the relationship between the ownership structure and firm performance. Agrawal & Knoeber (1996) studied how various mechanisms intended to control agency problems are related to firm performance, operationalized as Tobin's Q, reflecting the sum of market value of equity and book value of debt divided by the book value of total assets. They found that management ownership is positively related to firm performance, while increased debt financing, more outsiders on the board of directors, and greater corporate control activity were all negatively related to firm performance.

Morck, Shleifer & Vishny (1988) studied the relationship between management ownership and market valuation, as measured by Tobin's Q also. They found a non-monotonic relationship between the market valuation and the ownership by the board of directors. When the board's ownership of the equity increases from 0% to 5%, the market valuation also increases, whereas the valuation declines when ownership increases from 5% to 25%. Above 25% ownership, the market value increases again as the ownership rises. Morck et al. explained the negative relationship between the ownership and valuation by entrenchment effects of the board members. Morck et al. (1988) also observed that older firms run by a member of the founding family are valued lower than firms that are run by an officer unrelated to the founder.

Oswald & Jahera (1991) studied the relationship between inside ownership, measured in terms of stockholdings of both directors and officers, and firm performance, measured by excess stock returns. Their results showed a positive relationship between inside ownership and firm performance. Previous research on the relationship between inside ownership and firm performance has produced negative results also. For example, Oswald & Jahera (1991) found three previous studies indicating a negative relationship between inside ownership and performance (Kesner, 1987; Kim, Lee & Francis, 1988; Schellenger, Wood & Tashakori, 1989). In an international study, Han, Lee & Suk (1999) found no evidence that concentrated inside ownership and firm performance are related.

Although empirical research on family business has seldom used agency theory as a theoretical framework, recent development indicates that its application is gaining increasing interest among family business researchers. Empirical studies on family business that were identified as using an agency theory framework focused on ownership structure in family and professionally managed firms (Daily & Dollinger, 1992), corporate ownership and its impact on performance, efficiency, and capital structure (McConaughy, 1994), efficiency, risk, and value of founding family controlled firms (McConaughy, Matthews & Fialko, 1997), ownership and growth of family businesses (Hufft, 1997), the shareholder role in the family business (Vilaseca, 1999), and family chief executive officers versus non-family chief executive officers in the family controlled firm (McConaughy, 2000), effects of family ties on principal-agent contracts (Gomez-Mejia et al., 2001), types of agency problems within family firms (Schulze et al., 2001), and a survey of family business management issues related to agency theory (Chua, Chrisman & Sharma, 2001).

3.2.3 Critique to agency theory

Agency theory provides a robust theory to study organizations and it has been successfully applied in a variety of empirical studies. However, the agency theory is surrounded by controversy and it has been criticized by many authors, typically researchers in sociology. For example, Perrow (1990) argued that human beings do not inherently behave in a self-interested manner, as agency theory assumes. Organizational settings best explain whether self-interested or other-regarding behaviors will dominate. Perrow also claimed that agency theory focuses on agent opportunism, excluding the potential misbehavior of principals.

According to Uzzi (1997), agency theory, and also other theories of the firm rooted in neoclassical economics, does not explicitly recognize that social structure affects organizational behavior, thus bypassing the issues central to organization theory. This was recognized earlier by Granovetter who noted that economic theories of organization have "atomized, *under*socialized conception of human action" (1985: 483) because the impact of social relations and social structure are ignored. This undersocialized view emphasizes rational calculation of individual gain, while not taking into account social or kinship obligations. According to Granovetter, pure rational calculation may be applicable in competitive, idealized markets where buyers and sellers are anonymous to each other. However, Granovetter claimed "actors do not behave or decide as atoms outside a social context...attempts at purposive action are instead embedded in concrete, ongoing systems of social relations" (1985: 487).

Some critics indicate that application of agency theory outside of dyadic principal-agent relationships may not be feasible. For example, evolution and functioning interfirm network governance cannot be easily explained by agency theory, as principal-agent relationships are blurred, goals are often jointly set, and there is a lack of monitoring devices between firms (Larson, 1992; Uzzi, 1997). Often, social control mechanisms, such as collective sanction and reputation, are claimed to offer more suitable control mechanisms than formal control in a network-type governance context (e.g. Jones, Hesterly & Borgatti, 1997).

One source of criticisms on agency theory is the stakeholder theory, the development of which was greatly induced by Freeman (1984). Partly based on moral arguments, stakeholder theory claims that all stakeholders have intrinsic value, i.e. stakeholders deserve consideration for their own sake (Donaldson & Preston, 1995). Stakeholders refer to persons or groups who are "identified by their interests in the corporation, whether the corporation has any corresponding functional interest in them" (Donaldson & Preston, 1995: 67). Proponents of stakeholder theory claim that agency theory is not valid because it only addresses economic responsibilities between principals and agents, while being silent on other responsibilities (Shankman, 1999). Stakeholder theory places the management as the central decision-making actor, because, according to stakeholder theory, it is up to management to justify the needs of various stakeholders and make decisions concerning how to deal with these needs. Jensen has answered to these critics by noting that "proponents of stakeholder theory offer no explanation of how conflicts between different stakeholders are to be resolved. This leaves managers with no principle on which to base decisions, making them accountable to no one but their own preferences" (2000: 2).

Regardless of a variety of critics, agency theory is a powerful theoretical framework in many research contexts. Eisenhardt has recommended using agency theory with complementary theories. She concluded her review of agency theory by noting that "agency theory presents a partial view of the world that, although it is valid, also ignores a good bit of the complexity of organizations. Additional perspectives can help to capture the greater complexity" (1989a: 71). Following this recommendation, this dissertation complements agency theory with social capital theory.

3.3 Social capital theory

3.3.1 Introduction to social capital theory

The concept of social capital has emerged from the description of certain types of resources that are distinguishable from other forms of capital. Social capital can be broadly defined as an asset embedded in social relations and networks (e.g., Leana & Van Buren, 1999). Use of this concept focuses more on the positive consequences of sociability, and less on its potential negative effects (Portes, 1998). Social capital theory is not a unified, homogenous social theory. Rather, it is a set of related, but sometimes controversial, descriptions and propositions. The development of social capital theory has been affected by diverse streams of literature, such as that of the early social exchange theorists (Blau, 1964; Homans, 1961), community studies addressing resources acquired through personal ties (e.g., Jacobs, 1965; Putnam, 1995), and critics of neoclassical economics (e.g., Granovetter, 1985; Loury, 1981). The notion of social capital has gained an increasing interest in many fields because it is a productive asset that can be used to generate other forms of capital, including financial, physical, and human capital (Bourdieu, 1986; Coleman, 1988). However, social capital differs from other forms capital in that it is owned jointly by the members of a social network, and cannot be traded easily (Nahapiet & Ghoshal, 1998).

The social capital theory is used to study a wide range of social, economic, and organizational phenomena at various levels of analysis ranging from macro to micro levels. For example, it has been used to study nations (Fukuyama, 1995), communities (Putnam, 1993), family relations (Coleman, 1988), interfirm networks (Baker, 1990; Uzzi, 1997; Walker, Kogut & Shan, 1997), value creation by firms (Nahapiet & Ghoshal, 1998), intrafirm networks (Tsai & Ghoshal, 1998) and entrepreneurship (Larson, 1992).

Bourdieu, a French sociologist, was the first person to provide a systematic analysis of social capital (Portes, 1998). Bourdieu defined social capital as “the aggregate of the actual or potential resources which are linked to a possession of a durable network of more or less institutionalized relationships of mutual acquaintance and recognition” (1986: 248). According to Bourdieu, social capital has instrumental value because it helps to secure material and symbolic profits accruing from membership to a group.

These profits do not come without costs. Social capital is not a natural given, and it decreases over time if no conscious efforts are made. Bourdieu noted that “the network of relationships is the product of investment strategies...aimed at establishing or reproducing social relationships that are directly usable in the short or long term” (1986: 249). Bourdieu’s analysis suggests that the amount of social capital an individual possesses depends on the size of the network she or he has, and on the amount and quality of different resources available through the relationships in the network.

Coleman is another sociologist who has advanced the social capital concept, especially in the American context. Following Granovetter (1985), Coleman (1988) criticized both the “undersocialized” view of human actors as utility maximizing, independent individuals depicted by neoclassical economic theory, and the “oversocialized” conception in which man has no “engine of action,” as portrayed in earlier sociological literature. Coleman’s social theory (1990) imports principles from economics to sociology. Rational action and self-interested orientation are accepted as elements of human nature, but they are affected by the social structure. In Coleman’s analysis, social capital is seen much as a mechanism to create human and physical capital.

Coleman defined social capital by its function. According to Coleman, social capital “is not a single entity, but a variety of different entities having two characteristics in common: They all consist of some aspect of social structure and they facilitate certain actions of individuals who are within the structure” (1990: 302). Coleman (1988) identified three forms of social capital: (1) reciprocity expectations and obligations between two persons to whom earlier transfers of some resources will be repaid in some form in the future, (2) potentially useful information inhering in social relations, and (3) norms and sanctions to promote functional, and to inhibit dysfunctional behavior, within the network of social relationships.

After Bourdieu and Coleman, several definitions of social capital have been provided, both in theoretical analyses and empirical applications. Different contemporary definitions convey similar ideas. For example, Baker defined the concept as “a resource that actors derive from specific social structures and then use to pursue their interests; it is created by changes in the relations among actors” (1990: 619). Nahapiet & Ghoshal see social capital “as the sum of the actual and potential resources embedded within, available through, and derived from the network of relationships possessed by an individual or social unit" (1998: 243). Putnam referred to social capital as "features of social organization such as networks, norms, and social trust that facilitate coordination and cooperation for mutual benefit" (1995: 67). Portes defined it briefly as an "ability of actors to secure benefits by virtue of membership in social networks or other social structures" (1998: 6).

Consequences generated by social capital bearing upon individuals or larger social units are mediated by social structures and originated by the other members of the network (Portes, 1998). Although the extant literature does not always distinguish between the sources, mediating mechanisms, and consequences of social capital, there seems to be a consensus that the social capital includes both the social network and the resources obtained through that network.

Depending on who receives the benefits, social capital has been considered either as a public good or as a private good (Leana & Van Buren, 1999). Coleman (1988) considered social capital mainly as a public good, meaning that benefits due to social capital are distributed to all members in a social structure. In the public good view, the social capital is an attribute of a social unit and individual benefits are considered only as a secondary outcome (e.g., Putnam, 1995). Social capital as a private good implies that benefits accrue directly to individuals. For example, Belliveau, O'Reilly & Wade (1996) studied how social capital affects a firm's chief executive officer's compensation.

Authors on social capital suggest that the concept is multidimensional. Granovetter (1992) distinguished two types of "embeddedness" affecting economic action. The structural aspect of embeddedness refers to properties of social networks as a whole, whereas relational embeddedness is concerned with actors' dyadic (pair-wise) relations. Granovetter emphasized that the analysis of relations within a network cannot be reduced to an analysis of dyadic relations, because the network itself has properties that cannot be explained at dyadic level.

Drawing on and extending Granovetter's work, Nahapiet & Ghoshal (1998) suggested that the concept of the social capital has structural, relational, and cognitive dimensions.

The *structural* dimension describes the impersonal pattern of connections between actors within the social network. The structural dimension itself contains many facets, including the presence of network ties and overall network configuration in terms of density, connectivity, and hierarchy. The *relational* dimension addresses the quality of personal relationships among people as shaped by a history of interactions. As an asset, the relational dimension of social capital helps to create and leverage resources through personal relationships. Among the key elements of this dimension are norms and sanctions, trust and trustworthiness, obligations and expectations, and identity and identification. The *cognitive* dimension of social capital refers to resources providing “shared presentations, interpretations, and systems of meaning among parties” (1998: 244). According to Nahapiet & Ghoshal, this dimension has been substantially addressed in strategy literature (e.g., Conner & Prahalad, 1996), but it has not been addressed in the mainstream social capital literature. The three dimensions of the social capital suggested by Nahapiet & Ghoshal (1998) are closely related. For example, Tsai & Ghoshal (1998) found that the cognitive dimension of social capital, conceptualized as shared vision, and the structural dimension, conceptualized as social interaction ties, have significant effects on trust and trustworthiness, which represent the relational dimension of social capital.

Leana & Van Buren (1999) divided organizational social capital into two primary components. The first component is *associability*, which refers to individuals’ willingness to subordinate their own goals and actions to the collective goals and actions of an organization. The second component of organizational social capital is *trust*, which enables people to work together. Leana & Van Buren elaborated the concept of trust in terms its strength and the level of analysis. Leana & Van Buren’s classification of organizational social capital into associability and trust is consistent with Nahapiet & Ghoshal’s (1998) cognitive and relational dimensions.

For Coleman (1988, 1990), “closure” of social networks is an important determinant to the formation of social capital. Closure basically means that the ties among people are strong enough to guarantee the effectiveness of norms that contribute to achieving positive effects of social capital and to constraining undesired behavior. According to Granovetter (1973), tie strength between actors is a combination of the time commitment, the amount of reciprocal services, and the level of friendship in terms intimacy and emotions in the relationship. Like Coleman, many authors have emphasized the importance of tie strength: the stronger the ties among the members in the social network, the higher the level of social capital within that group. For example, Putnam (1995) has pointed out how social capital within American families and communities help them to survive and prosper, and how the declining social capital in these units is associated with social and economic problems. Nelson (1989) found from an empirical study that strong ties between organizational units are associated with low levels of disruptive conflict.

Arguments that favor weak ties between groups have also been proposed in the literature. Weak ties can increase information flows between otherwise disconnected social groups (Granovetter, 1973). Burt (1992) extended Granovetter's idea of weak ties to the social structure of competition. Burt showed how "structural holes" can be used create information and control benefits in competition. A structural hole indicates non-redundant contacts, i.e. contacts having weak ties and high new information potential. Walker et al. (1997) studied empirically whether strong tie or weak tie arguments better explain the formation of an industry network. They found evidence that dense social capital has more positive effects on new cooperation for creating information benefits, than the use of weak ties. In sum, the extant literature suggests different functions for strong and weak ties: strong ties are more associated with enhancing the cohesiveness and voluntary cooperation within a social unit, whereas the utilization of weak ties is associated with entrepreneurial activities.

3.3.2 Social capital in corporate governance and family business research

The application of social capital theory and related approaches to corporate governance research has been scarce. The absence of the social capital theory is visible, for example, in two past reviews on research on boards of directors (Johnson, Daily & Ellstrand, 1996; Zahra & Pearce, 1989). However, some recent corporate governance studies have used social capital theory as their theoretical framework. Huse (1993; 1994) conducted some pioneering research on combining economic and social approaches to the study of the relationship between boards of directors and management. By complementing agency theory with relational norms (Macneil, 1980), Huse developed and tested hypotheses explaining how boards of directors may remain independent from management while retaining a close relationship with it. As mentioned earlier, Belliveau, et al. (1996) studied the effects of social capital on a firm's chief executive officer's compensation. They found a positive relationship between the compensation and CEO's social resources. In the received corporate governance literature, the relationship between the board of directors and the firm's top management is considered more formal and impersonal, rather than socially embedded. Low sociability between board and management is often seen as necessary to guarantee the board's independence. Challenging this view, Westphal (1999) found that social ties between board and chief executive officer could contribute to board effectiveness without reducing its control over the management. Gulati & Westphal (1999) studied how social networks based on the board interlocks influence strategic alliance formation. Their results indicated that the likelihood of alliance formation is increased when top managers of corporations are linked through interlocking directorates, thereby enhancing trust.

A stream of social psychological literature, the procedural justice theory, addresses the question of the fairness of various social processes and procedures (Lind & Tyler, 1988). Although social capital theory and procedural justice theory are not explicitly linked, they can be considered as closely related. Procedural justice in the decision-making process is concerned about how the people who are most affected by decisions being made are involved in the process. Korsgaard, Schweiger & Sapienza (1995) found that involvement of decision-making teams in the strategic decision-making process is related to their trust in ultimate decision makers. Sapienza & Korsgaard (1996) applied a similar framework to entrepreneur-investor relations. They found that procedural justice in decision making is related to investors' trust in entrepreneurs, representing the relational dimension of social capital among the investors and entrepreneurs.

Social capital based research has attracted more attention in interfirm governance than in corporate governance studies. Corporate governance and interfirm governance share similar interorganizational challenges, because they both address how value is created and appropriated among different organizational units. Thus, ideas about how the social capital framework has been applied to interfirm governance should generally be applicable to corporate governance. As discussed earlier, transaction cost economics has dominated the area of interfirm governance. However, transaction cost economics has been criticized in not offering a good framework for longer-term cooperative arrangements between firms because it does not address social control aspects inherent in those relationships (Ghoshal & Moran, 1996). Consequently, approaches related to social capital theory have gained increasing interest in interorganizational and network governance research (Das & Teng, 1998; Dyer & Singh, 1998; Jones et al., 1997; Gulati, 1995; Kale, Singh & Perlmutter, 2000; Nooteboom, Berger & Noorderhaven, 1997; Ring & Van de Ven, 1992; Ring & Van de Ven, 1994; Zaheer, McEvily & Perrone, 1998; Zaheer & Venkatraman, 1995). All these studies criticize transaction cost economics and propose alternative forms of governance based on some social mechanism, such as trust, reputation, and norms of reciprocity.

Ouchi (1980) argued that transaction cost theory falls short in explaining certain forms of governance. In addition to markets and bureaucracies, which are alternative mechanisms for mediating transactions, he proposed a third form of governance. He termed the third governance mechanism "clan" form. Whereas bureaucratic organization relies on hierarchical control and evaluation, clan control is based on creating goal congruence by means of a variety of social mechanisms and strong community. The greater goal congruence is expected to reduce opportunistic behavior and lower transaction costs. Moores & Mula (2000) applied Ouchi's (1980) market, bureaucratic, and clan controls framework to Australian family companies. Results of their empirical study indicated that family businesses in their earlier life cycle stages were more likely to employ clan-based controls than bureaucratic controls. Clan-based social controls are rooted in traditions rather than in rules or prices.

Interorganizational governance lies somewhere between the two extremes of market and hierarchy controls. Ring & Van de Ven (1992) have argued that transaction cost economics yields poor explanations of interfirm governance because it is based on cost efficiency considerations only, and does not address the effects of social relations in repeated transactions between firms. They proposed that trust, i.e. "confidence in other's goodwill" (1992: 488), is the key element in interfirm governance because it is related to reduced risk of opportunistic behavior in repeated transactions. Drawing from social capital related literature, Ring & Van de Ven (1994) further developed their framework for interorganizational relationships. They addressed formal, legal, and informal social aspects of the relationship over time.

The social capital theory has not rigorously been applied in family business research. This is surprising, considering that family businesses are characterized by overlapping and dense relationships among the owners and management. During the literature review on family business, only one article explicitly using social capital theory as the framework was found. It was a paper by Green (1996), who proposed a social capital theory driven research agenda linking family businesses and rural communities. Otherwise, family business literature has only implicitly used some facets of the social capital theory, usually as part of a descriptive or qualitative analysis, and sometimes as part of a quantitative analysis.

For example, Miller & Rice (1967) noted that strong personal ties among family members can reinforce and support leadership of a family company, but they also noted that these strong ties can be disastrous during times of rapid change within the business. In an empirical study, Lansberg & Astrachan (1994) found that family relationships influence management succession. Their regression analyses showed that owner-manager and successor relationship mediates the effects of family cohesion on succession planning and training.

As a form social capital, trust can be a powerful force in family business. LaShapelle & Barnes suggested that trust, defined as positive expectations of another person's behavior" (1998: 2), within the family can act as an integrative mechanism for succeeding generations of the family business. Trust is created and maintained within and beyond the family by "trust catalysts," persons that mainly come from the family.

3.3.3 Critique to social capital theory

Social capital theory has been criticized for not offering any new social theory, but rather the processes addressed by social capital theory have been previously studied under other labels (Portes, 1998). Also, definitions of social capital are often vague and even contradictory. Portes observed that Coleman started definitional proliferation "by including under the term some of the mechanisms that generate social capital...the consequences of its possession..., and the ‘appropriable’ social organization that provided the context for both sources and effects to materialize” (1998: 5).

Social capital theory focuses on positive consequences of sociability while it seems to largely ignore the negative effects to individuals and groups. Portes (1998) identified four negative consequences of social capital. First, access to social networks by outsiders may be impossible due to insiders’ tight control. This kind of “bounded solidarity” is common among ethnic groups. Second, a free-riding problem may occur if less diligent group members’ enforce all kinds of demands backed by shared norms. Third, social control aiming at greater conformity in a community or group may reduce individual autonomy excessively. Fourth, downward leveling norms may result in groups that are in some way in opposition to mainstream society. High social capital can involve high risks. Granovetter (1985) noted that trust, following from personal relationships, creates a potential for enormous malfeasance. The higher the trust, the greater is the potential benefit from malfeasance.

Also, groups with strong social capital may have created rigidities that inhibit survival and performance of those groups. For example, Janis (1982) argued that “groupthink” in convergent groups might lead to poor decision making. Leana & Van Buren (1999) noted that groupthink is related dysfunctionally stable power structures because preferences of those who are in power are favored. Negative effects of strong, convergent groups may be reduced by norms of interaction, such as openness to criticism and information sharing (Leonard-Barton, 1995).

Finally, one potential downside of high social capital in organizations is the resistance to change and a reduced level of innovation. Although social capital can be seen to induce innovation due to an increased level of risk taking and cooperation through trusting relations (e.g., Jones & George, 1988), it can also hamper innovation (Leana & Van Buren, 1999). Flows of new information entering the organization tend to become less as the relationships become denser and more stable (Staw, Sandelans & Dutton, 1981). Also, innovation may be reduced in closed industrial communities due to strong norms of keeping trade secrets (Coleman, 1990).

Social capital literature does not discuss the costs of achieving social capital as much as the benefits. Although some forms of social capital may be obtained as a byproduct of social processes, the development of social capital requires intentional investments. For example, Leana & Van Buren (1999) have argued that maintaining organizational social capital calls for keeping slack human resources, providing job security, and maintaining good ongoing relationships. Bourdieu emphasized that reproduction of social capital "presupposes an unceasing effort of sociability, a continuous series of exchanges in which recognition is endlessly affirmed and reaffirmed" (1986: 250). These views imply that in order to obtain benefits through social capital, investments based on both managerial and individual initiatives are needed.

3.4 Overview of literature on strategic decision making

Decision making is a central topic in strategic management, organization theory, and economics. Frameworks relating to decision making are diverse, ranging from mathematical formulations to behavioral approaches. This chapter reviews decision making literature relevant to governance and strategic management.

Human beings do not have unlimited cognitive capabilities as decisions makers. This was pointed out by Simon (1955; 1976) who criticized the assumptions of rational "economic man." Simon noted that people have limited capabilities of accessing and processing information. Decision alternatives are examined in a sequential fashion and an alternative, which is satisfactory as defined by the "aspiration level," will be selected. Knowledge of consequences of decision alternatives is always incomplete and only few of all the alternatives ever come to mind. According to Simon, human behavior can be "intendedly rational" to the extent that an organizational actor is "*able* to pursue a particular course of action, he has a correct concept of the *goal* of the action, and he is correctly informed about the conditions surrounding his action" (1976: 241). Because of the "bounded rationality" of human beings, attainment of goals are only "satisfied," rather than maximized (Simon, 1976).

Building on Simon's work, Cyert & March (1963) presented "a behavioral theory of the firm" as an attempt to address some issues related to economic decision making that neoclassical economic theories did not handle. Analysis of Cyert & March was based on observations of decision-making behavior on economic decisions like price, output, and product mix. Assumptions of profit maximization as the firm's goal and existence of perfect knowledge were challenged by Cyert & March. According to Cyert & March, there are two classical solutions to goal conflict. The first solution posits that the goals of an entrepreneur are also the goals of the whole organization. People are hired, paid, and controlled to attain the goals. The second solution is that goal conflict is eliminated through consensus. The authors were not content with either solution. They suggested that organizations do not have goals, but that individuals do. Furthermore, these goals are often in conflict, they are never fully resolved and they are formed by bargaining processes occurring within a coalition of diverse individuals and groups.

In the introductory chapter to Barnard's seminal book ([1938] 1968), Andrews noted that, although Barnard, and later Cyert & March (1963) discussed some characteristics of the goal formation processes of well specified economic issues, they seem not to have addressed the broader policy-making processes and how the organizational purpose and goals come into existence. Later, strategic management literature extensively addressed both goal formulation processes and the means of achieving organizational goals. Approaches to the strategic ends-means issue are diverse (Bourgeois, 1980; Mintzberg, 1973). One dominant approach has been sequential, planned strategy formulation: the organizational goals are decided first and then strategies to pursue the goals are developed (e.g., Andrews, 1971; Ansoff, 1965; Lorange & Vancil, 1977; Porter, 1980). Another stream of literature has emphasized the adaptive or incremental nature of strategy formulation, where ends and means may evolve as a parallel process (e.g., Quinn, 1980; Wrapp, 1967). The adaptive view may involve political elements in the form of conflicting goals and coalition formation (Pfeffer & Salancik, 1978). Goal ambiguity may have adaptive value when it allows managers better to take into account the local conditions and constraints of decision making (Bourgeois, 1980). How well the goals and strategies reflect a company's ever changing external and internal realities seems to be an important determinant of the company's survival and success (Aldrich, 1999). This implies that goal setting and strategy selection is a dynamic process, and that this may require the use of different renewal processes in different situations, depending on how dynamic the business environment is (Baden-Fuller & Volberda, 1997; Burgelman & Grove, 1996).

How much can managers, and people in organizations generally, affect decision making and the outcomes of decisions made? The strategic choice perspective emphasizes the effects that executives can have on strategic decisions (Child, 1972). At the other end of continuum is the external control view that emphasizes the role of the environment in determining strategic decision making (e.g., Hitt & Tyler, 1991). According to the *strategic choice view*, the "dominant coalition" of an organization makes strategic choices based on its evaluation of the organization's position in terms of stakeholder expectations, environmental trends, and various internal conditions (Child, 1972). The contribution of the strategic choice perspective to organization theory is its explicit recognition that formal decision-making structures affect an organization's decision-making effectiveness. According to Child, the earlier behavioral decision theory (Cyert & March, 1963) did not address this structural dimension in its analysis decision processes. The strategic choice perspective has been elaborated by the "upper echelon" view proposed by Hambrick & Mason (1984). This view addresses effects of various individual and group characteristics of executives on strategic decision making and organizational performance. The strategic choice and upper echelon views have influenced research on strategic decision making teams. This stream of research has addressed, for example, power in top management teams (Finkelstein, 1992), top management team heterogeneity and competitive moves (Hambrick, Cho & Chen, 1996), and executives' cognitive diversity and strategic decision processes (Miller, Burke & Glick, 1998).

The *external control* view claims that external environment largely constrain managers' decision making (Romanelli & Tushman, 1986). The proponents of this deterministic perspective come from diverse perspectives (Hitt & Tyler, 1991). Organizational ecologists (e.g., Hannan & Freeman, 1977) and resource dependence theorists (e.g., Pfeffer & Salancik, 1978) suggest that organizational design and strategic choices are determined by environmental complexity. Industrial economists (e.g., Porter, 1980) claim that an industry's competitive forces largely determine feasible strategic alternatives available to a firm. Much of strategic decision making literature seems to settle somewhere between the strategic choice and external control perspectives, implying that both managerial and external contingencies are important determinants of strategic decision making.

Several authors have suggested categorizations for decision making models (Allison, 1988; Eisenhardt & Zbarachi, 1992; Hitt & Tyler, 1991; Nutt, 1976; Pfeffer, 1987). Three such partly similar categorizations are briefly reviewed below. Using decision making in the Cuban missile crisis as a case, Allison (1988) and Allison & Zelikow (1999) categorized decision making into three conceptual models: rational actor, organizational process, and bureaucratic politics. The *rational actor* concept features a sequential decision process including four distinctive areas: (1) existence of goals and objectives, (2) generation of options for solving the strategic problem, (3) analysis of likely consequences, both benefits and costs, in terms of goals and objectives, (4) making a rational choice that maximizes the value as compared to the organizational goals and objectives. The rational actor portrays a simplistic picture of decision making in organizations because it assumes a completely informed, centrally controlled, value-maximizing decision maker. The *organizational process* model is, according to Allison (1988), a more realistic decision making model because it views decision making more as outputs of organizational behavior, and less as deliberate choices of leaders. Managerial decision making is greatly influenced by "standard operating procedures," which help to coordinate complex routines. Organizational goals are seen as constraints defining acceptable performance. Rather than maximizing value in terms of goals, uncertainty avoidance is characterized in this mode. The *bureaucratic politics* model regards the decision-making process as a competitive game, and decisions as "outcomes of bargaining games" (Allison, 1988: 320). A decision is not chosen as the best alternative, but it results from coalitions and competition among organizational decision makers.

Pfeffer (1987) described and compared four organizational decision making models that he calls rational choice model, bureaucratic model, decision process model, and political model. The *rational choice model* is similar to Allison's rational actor concept. Rational choice models relies heavily on information processing, whereas choices in bureaucratic decision making are made according to rules and procedures that have been effective in the past. Similarly, as in Allison's organizational process model, in Pfeffer's *bureaucratic model*, goals are seen as constraints defining acceptable performance. Decisions evolve during a limited search guided by organizational policies, procedures, and rules until an accepted compromise is achieved. In this model, procedural rationality is substituted for substantive rationality. Pfeffer's bureaucratic model is influenced by Simon's (e.g., 1976) notion of bounded rationality. The *decision process model* is even more random in goal setting and functioning than bureaucratic models. *Political models* of organization recognize that there is a diversity of interests and goals within organizations. Relative power and preferences of each actor determine outcomes of decisions processes.

Eisenhardt & Zbarachi (1992) categorized approaches to strategic decision making under three “dominant paradigms”: rationality and bounded rationality, politics and power, and garbage can. *Rationality and bounded rationality* perspective builds on the rational choice model, but elaborates different forms of human cognitive limits. The *politics and power* perspective of decision making originates from political science literature. This stream of literature emphasizes that people have different goals, they form coalitions, and that preferences of powerful actors win. The *garbage can model* describes decision making in ambiguous, complex, and unstable organizational settings where goals are ill defined, people have only a loose understanding of the ends and means, and participation in decision making is fluid. According to Eisenhardt & Zbarachi, the term “garbage can model” was introduced by Cohen, March & Olsen (1972). In this model, decisions are regarded as results of “random confluence of events,” rather than choices of bounded rational actors or the bargaining of people in a coalition. Eisenhardt & Zbarachi argue that rationality and bounded rationality, and politics and power perspectives portray strategic decision making behavior well, whereas the garbage can perspective is less relevant.

The extant literature indicates that the effectiveness of a decision process can be analyzed according to several criteria. The decision process can be evaluated according to the qualities of the decision process itself and the characteristics of decision outcomes. The decision process can be assessed on the basis of how rational it is. Rationality can be measured by decision comprehensiveness, which is defined by Fredrickson & Mitchell as “the extent to which an organization attempts to be exhaustive or inclusive in making and integrating strategic decisions” (1984: 402). Phases of the decision process, providing the basis on which to evaluate decision comprehensiveness, have been described in the extant literature in many different ways. For example, Janis (1989) broke down the decision process into seven areas: (1) surveying a range of objectives, (2) canvassing a wide range of alternative courses of action, (3) intensively searching for new information, (4) assimilating and taking into account new information, (5) reconsidering the negative and positive consequences of alternatives before the final choice, (6) carefully weighing the costs and risks of various consequences, and (7) making detailed implementation plans. Mintzberg et al. (1979) described the strategic decision process using a framework of three broad phases, consisting of identification, development, and selection processes. Previous research has yielded conflicting results about the relationship between the strategic decision making process rationality and firm performance (e.g., Priem, Rasheed & Kotulic 1995). The effectiveness of the decision process can be assessed by analyzing the direct consequences of the decision process, that is, the decision itself.

To assess the outputs of the decision process, three broad criteria can be identified from the literature (Dooley & Fryxell, 1999; Eisenhardt, 1989b; Janis, 1989; Johnson & Scholes, 1999; Korsgaard et al., 1995; Mintzberg, 1995; Vroom & Yetton, 1973). First, the decision process can be judged on the basis of qualities of a decision made, i.e. its potential to solve a specific problem or its potential to contribute to attaining organizational goals. Second, the decision process can be assessed on the basis of how well the selected decision alternative is being executed. The third criterion pertains to the time dimension of a decision process. Good decision process can deal with time pressures both in the planning phase and in the implementation phase. The decision process and outcomes are further elaborated in Chapter 4, which develops the study's theoretical models and hypotheses.

3.5 Literature related to family firm governance

3.5.1 Unique characteristics of family business

The question about what are the unique, defining characteristics of family businesses have been under debate since the early writings on the field (e.g., Donnelley, 1964). Although there is no generally accepted description of what constitutes a family business, several unique characteristics have emerged in the extant literature. The following underlying unique characteristics of family businesses can be identified from the literature: (1) the controlling ownership lies in the hands of a given family, (2) the family has an influence on the firm's decision making, and (3) the members of the controlling blockholder, i.e. the family members, are bonded by family ties (Gersick et al., 1997; Hoy & Verser, 1994; Landsberg, 1999; Tagiuri & Davis, 1982). Although there are large variations in ownership patterns, in family members' participation in the business, and in the quality and structure of familial ties, these three characteristics seem to capture the essence of family businesses. Tagiuri & Davis (1982) depicted in their "three-circle" model the family business as a system consisting of three overlapping but distinctive groups, as shown in figure 3.1. The figure indicates that an individual can be in one or more different roles in the family business.

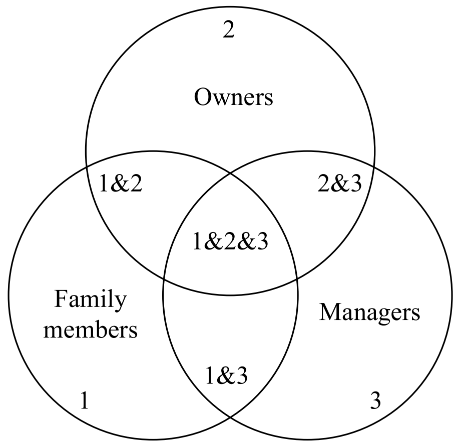

Figure 3.1 Family business system (Tagiuri & Davis, 1982)

While the systemic approach is widespread and useful in describing family businesses, it emphasizes the macro level (Hollander & Elman, 1988). Thus, the systemic approach may ignore micro level phenomena like interaction between family members. To complement the systemic view of family business, the dissertation addresses additional unique characteristics that are organized under the following five headings: (1) enduring exchanges, (2) emotional dimension of the family business, (3) high amount of conflict, (4) low mobility of shares, and (5) mixed self-interested and altruistic behaviors.

Enduring exchanges

In family business exchanges are inherently enduring because the patterns of ownership and family ties tend to change slowly. However, changes do inevitably occur, sometimes abruptly. The family is tied together by the interpersonal relationships among family members both horizontally across the family and vertically over succeeding generations (Harvey, 1999a). Relationships are intensified further because the family members participate in the family business system via multiple roles, both within the family and in the business. The cohesiveness is perhaps the most fundamental measure of the effectiveness of the family shareholder group (Davis & Herrera, 1998; Walsh, 1994). Cohesiveness reflects the amount of mutual support and how tightly connected the members in the group are, thus influencing the quality of exchange relationships within the family firm. Although there are many hurdles that threaten the continuation family businesses (Ward, 1987), the owners of family firms have “an insatiable desire” to enable their businesses to exist and prosper over the long run (Hoy & Verser, 1994).

The chain of relationships in a family firm can extend through multiple generations. Over time, behavior becomes more institutionalized by the organizational culture, involving shared assumptions, values, and norms helping to cope with problems of external adaptation and internal integration (Schein, 1983). Culture of the family business is reflected in behaviors, language, and symbols expressing those assumptions and values, providing identity and meaning for the individuals involved (McCollom, 1988). Dyer (1988) has suggested that the family business culture is an important factor determining the success of the family business beyond the first generation. The strength of the culture and familial norms determine how the family contributes to the success of the business (Harvey, 1999a).

Emotional dimension of the family business

It has been suggested by many authors that family businesses have an emotional dimension due to the family’s connection to their business (e.g., Davis & Herrera, 1998; Davis & Stern, 1980). Emotions, as individuals’ subjective experiences, are likely to affect relationships within the family firm. Extant literature has often labeled the family as the emotional arena and the business as the rational arena (Danes et al., 1999). Whiteside & Brown offered a more realistic view by noting that “no business is totally task-oriented and no family is totally emotional” (1991: 386). Mainstream management and organization literature may have exaggerated the virtues of rational thinking at the cost of “non-rational” thinking. Dyer has noted that “family dynamics in business settings has historically been assumed to be irrational and unproductive, and therefore not worthy of serious study" (1994: 110). Dyer & Handler (1994) have suggested that the family-business connection may be a source of sustained competitive advantage. Also, research on strategic decision making has recognized the potential value of emotion to cognitive processes, and thus, to the quality of decisions (Eisenhardt & Zbaracki, 1992). To summarize, emotion-based family dynamics can be a strong force in family businesses. Both positive and negative effects of family dynamics to family businesses have been reported (Kets De Vries, 1996).

High amount of conflict

Family businesses are fertile ground for conflict. Types of conflicts in family businesses are numerous, including, for example, justice conflicts, role conflicts, work-family conflicts, identity conflicts, and succession conflicts (Danes et al., 1999), struggles regarding power and control (Cosier & Harvey, 1998), role ambiguity, sibling rivalries, conflicts between family members and non-family employees (Dyer, 1994), communication difficulties, business decisions that negatively affect the family (Harvey & Evans, 1994), and long-standing family feuds (LaShapelle & Barnes, 1998).

One source of conflict in family businesses is the interaction of two qualitatively different social institutions, the family and the business. The task of the family is to provide care for and secure the development of its members, whereas the purpose the business is to produce goods and services at a profit (Kepner, 1983; Lansberg, 1983). It is often argued in family business literature that conflicts in family businesses have an emotional origin (Cosier & Harvey, 1998; Kets De Vries, 1996), or that conflicts are "functions of the psychodynamics of the family" (Dyer, 1994: 118). Interpersonal, emotion-based "affective" conflict is generally considered as disruptive, and thus, it should be avoided (Amason, 1996).

Contrary to the majority of conflict-related family business literature, not all the conflicts in family firms need to be dysfunctional or disruptive. Indeed, management theorists claim that certain types of conflicts may help organizations survive due to the broader cognitive perspectives they induce (e.g., Amason, 1996). Cosier & Harvey emphasized the potentiality of healthy conflict by noting that “if mutual trust can be established and maintained, there is an opportunity for more effective collaboration between family business members by encouraging and using constructive conflict to identify win-win outcomes” (1998: 77).

Low mobility of shares

Because of the very nature of the ownership of family businesses, the shares of family firms are relatively illiquid. Often the shares are transferred through inheritance and other transfers within the family. Also, family firms generally have limited capital resources. After the initial equity capital has been injected into the business, new financing can be obtained from multiple sources, including retained earnings, new equity capital from current and new shareholders, selling parts of the business, and through loans (Neubauer & Lank, 1998). Some family firms have opted to go public by allowing a certain number of its existing shares to be traded on a stock exchange or by issuing new shares. While going public can improve the poor liquidity of shares and provide a new source of capital, it also requires more formal governance structures, reduces company privacy, and incurs additional administrative costs (Neubauer & Lank, 1998; Wagen, 1996).

There is a trade-off between the family’s ownership control and access to new equity capital. Dreux (1990) has noted that the competing needs of ownership control, capital needed in business, and liquidity of ownership constitute a special challenge to family firms. Consequently, conflicts over payout and investment policies are common in family firms, and the limited availability of capital may hamper making optimal investment decisions and constrain company growth (Fama & Jensen, 1985).

In large publicly traded corporations, the shareholders’ return on investment comes from the combination of the share price appreciation and dividends. When the shares of family firms are not easily traded, the share price appreciation is not part of the expected return. Thus, in family firms, the owners’ financial return comes largely from the dividends (Thomas, 2001). This places additional pressures on otherwise scarce financial resources of family firms.

Owners of the family firm resemble one type of institutional investor that Brancato (1997) labeled as a “relationship investor.” The relationship investor takes large positions in a relatively few number of stocks, holds them for long period of time, and actively monitors the investment. The relationship investor seeks to build in-depth relationships with the companies in the portfolio and to influence long-term shareholder value by participation in corporate governance. However, share-owning family members and institutional relationship investors differ markedly in the degree of professionalism. While the capabilities and approaches to effective ownership seem to greatly vary among family businesses (Gnan & Montemerlo, 2001), the institutional investors manage shareholdings on a professional basis.

Mixed self-interested and altruistic behaviors

Agency theory assumes that individuals are self-interested and aim at maximizing their own utility. As discussed earlier, the adoption of self-interested behavior is not inconsistent with altruistic behavior (Jensen, 1994). Also, Jensen argued that there are no “perfect agents” who will exclude their own preferences when they act in the interests of others. In diffusely-owned, publicly traded corporations, agency problems caused by managerial self-interested behavior are accepted as being part of the game and this unwanted behavior is controlled by external and internal governance mechanisms as well as by norms of professional management.

In family firms, the incidence of self-interested or altruistic behaviors, and the way they affect the business, are not well known. Different interests in a family business may become blurred because of the interaction of the two qualitatively different social institutions of the family and the business (Lansberg, 1983). On the one hand, altruistic behavior is one of the defining elements of family institutions. Lansberg has noted that “the family’s primary function is...to assure the care and nurturance of its members” (1983: 40). On the other hand, the purpose of a business is to profitably serve its product markets through organized action. Because of the “institutional overlap” between the family and the business, those family members who are employed in the business, may be favored in terms of employee selection, compensation, appraisal, and training

(Lansberg, 1983). Kets De Vries argued that nepotism, i.e. "blatant imbalance between contribution and credit," (1996: 19) leads to a loss of trust among non-family employees that influences their job satisfaction, motivation, and performance.

Compared to large publicly traded corporations, family firms have fewer agency problems when residual claims are restricted to important decision agents, i.e. managers who are also family members (Fama & Jensen, 1983b). In addition, self-interested behavior may be reduced by management's familial ties because "between close friends and family members altruistic motivations assume an importance not found in dealings between strangers" (Demsetz, 1997a: 5). However, family firms may experience "owner opportunism" (Schulze et al., 2001). According to this view, agency hazards in family firms may be caused by a lack of a market for corporate control, self-control problems, adverse selection, and biased incentive structures due to altruism.

Self-interested and altruistic behaviors are considered as rational behaviors (Jensen, 1994). Family businesses seem to experience also non-rational or dysfunctional behaviors. Family business literature is full of evidence of such behaviors associated with family dynamics (e.g., Harvey & Evans, 1994; Kets De Vries, 1996).

3.5.2 Research on family firm governance

Research on family business governance is scarce, as noted earlier. So far, the most comprehensive overview on family business governance has been provided by Neubauer & Lank (1998). They define corporate governance as "a system of structures and processes to direct and control corporations and to account for them" (1998: 60). In this definition, *controlling* refers to oversight of management, whereas *accounting for* refers to responsibility towards the stakeholders. They apply this quite broad definition to the governance of family firms, taking into account the distinctive nature of family businesses. Figure 3.2 summarizes the key elements of family business governance presented in Neubauer & Lank's book.

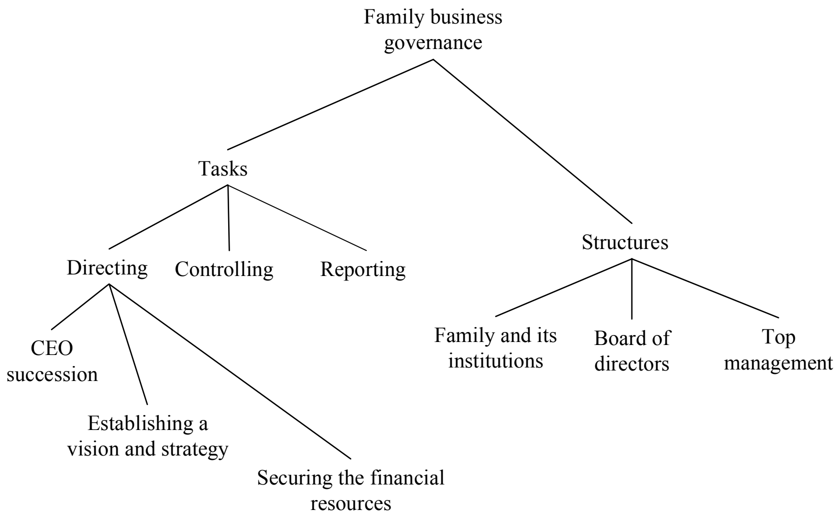

Figure 3.2 *Key elements of family business governance (summarized from Neubauer & Lank, 1998)*

The system of family business governance, as depicted in Figure 3.2, reflects the unique characteristics of family businesses. For example, management succession, special challenges of financial issues, and the family's internal structures and processes present all specific family business governance issues. The systemic nature of family business, addressing the overlapping domains of the family, ownership, and management, is evident in the Neubauer & Lank's book.

Roles, characteristics and activities of the boards of directors, as well as their causes and consequences, have been central issues in corporate governance in both scholarly research and in the business press. At least five reviews of research on boards of directors have been conducted in the recent past. They are in chronological order: Zahra & Pearce (1989), Pettigrew (1992), Johnson et al. (1996), Forbes & Milliken (1999), and Huse (2000). It is noteworthy that these reviews do not specifically address family firm governance. However, research on boards of family firms benefit from these reviews. Zahra & Pearce (1989) analyzed boards of directors from four theoretical perspectives, including legalistic, resource dependence, class hegemony, and agency theory perspectives, from which they described how various roles of boards of directors, such as control and service, are linked to strategic outcomes and firm performance. They also identified a number of contingencies (e.g. company size) and board attributes (e.g. composition) that influence how the boards act in their various roles. Pettigrew (1992) reviewed a number of earlier studies on boards of directors addressing a variety of theoretical, methodological, and practical issues. In particular, he called for more research on how the boards actually function, in addition to easily observed attributes such as composition. Johnson et al. (1996) analyzed past research by classifying directors' responsibilities into three roles, i.e. control, service, and resource dependence. They concluded that research on boards of directors has not been able to produce unified results. Forbes & Milliken (1999) focused more on the board level processes, and how these impact board effectiveness in terms of fulfilling the control and service tasks of boards of directors. To better understand how board processes are linked to board effectiveness, Forbes & Milliken developed a model that specifically focuses on the boards' cognitive capabilities contributing to board effectiveness. Forbes & Milliken also recognized that governance of small firms is distinct from that of large firms. The review of Huse (2000) is the only one among the five reviews that focuses specifically on the boards of directors of small and medium-sized enterprises (SMEs).

Huse's (2000) review, in addition to addressing SMEs specifically, can be seen as a critical evaluation of past research on boards of directors and a proposal for future research directions. Huse argued that (1) past research on boards of directors has largely studied large U.S. corporations, often using secondary archival data, (2) methodologically, research has focused on multivariate techniques in cross-sectional settings, (3) research questions have rarely addressed phenomena other than links between board composition and firm performance. According to Huse, "few significant findings have been found" (1993: 274) by this mainstream research. To gain a better understanding about what is happening in and around boards of directors, Huse urged researchers to open the "black box" by employing alternative samples, alternative concepts and relationships, and alternative methods. Samples should also include small firms, in addition to large firms, and in the European context too. Based on received governance literature, Huse developed an integrative framework for researching boards of directors. The framework emphasizes an open system approach to the study of board-stakeholder dynamics. Concerning methodology, Huse recommended the use of more longitudinal research settings to improve the understanding of the causal relationships between the phenomena under study. In sum: most of the literature on the boards of directors has focused on large corporations, as discussed above, while research on the boards of small and medium-sized enterprises is gaining increased attention (Huse, 2000).

Literature specifically addressing the boards of directors of family firms is still scarce. Broadly, the extant literature has identified two important roles for the boards of directors: oversight of management and counsel in the strategy process (e.g., Mace, 1972; Zahra & Pearce, 1989). Boards of family firms may have specific roles in linking the family and the company (Corbetta & Tomaselli, 1996). Mueller (1988) and Whisler (1988) have noted the board can act as a mediator in solving family conflicts. On the other hand, some authors have suggested that the board should not be involved in family-related matters (e.g., Schwartz & Barnes, 1991). Variation in the board roles in family firms can be large, varying from the most passive to a very active (Neubauer & Lank, 1998).

Researcher and practitioners often argue that outside representation on the board is desired. Outside members are expected to bring expertise, independence, and objective views to the board of directors. In the family firm context, outside members usually refers to those board members who are not part of the owner family or of the management (Ward & Handy, 1988). Ward (1991) has given a comprehensive picture of the role and operations of the boards in family corporations. He emphasized the value of boards with outside influence in multiple roles, addressing both business issues and the needs and interests of the owner family members. Schwartz & Barnes (1991) concluded in their research that outside members could improve the quality of decision-making processes. Schwartz & Barnes claimed that to obtain useful contributions from outside members, three conditions must be satisfied: an honest desire for an outside board, proper process to select the outside members, and realistic expectations about the contribution that outside members can provide. Also, Johannisson & Huse (2000) have stressed the importance of the selection process of outside members. They proposed that entrepreneurial, managerial, and familial aspects need to be considered in the selection process. Outside board member representation is likely to change during the company's different life cycle phases. As the company grows and the ownership disperses, the amount of outside members is likely to increase (Gersick et al., 1997). Although the value of outside directors is widely accepted, they are still an underutilized resource in the family firm board (Brunninge & Nordqvist, 2001; Corbetta & Tomaselli, 1996).

Some authors are skeptical of the value of outside members. Ford (1988; 1989) criticized the normative recommendations that outside directors should be used in privately owned firms. Improving internal management would, in many cases, be a more effective way to improve the business than using outside boards. On the basis of a survey and subsequent interviews, Ford concluded that outside directors seem to have less value because of their lack of specific knowledge of the firm and their lack of availability to the firm. Jonovic (1989) claimed that the "classic" outside board does not provide the best governance structure to the majority of family businesses due to their unique governance challenges. There might be an optimal ratio of independent, outside directors in the board of a family company. While outside members may provide independent expert opinions, inside members may provide deeper understanding of the family culture. Lansberg (1999) have suggested that there should be a balanced mixture of external and internal members in the board in order to guarantee that all relevant views are represented. Internal members can include both family members and non-family management team members. However, Lansberg suggested that the majority of directors should come outside from the company and family, at least in larger family firms.

The unique characteristics of family firms, as discussed in chapter 3.5.1, call for specialized governance structures. The systemic views on family business provide a foundation to family business governance, because the key sub-systems and their relations are identified (e.g., Tagiuri & Davis, 1982). While the mainstream corporate governance of large corporations focuses on the ownership-management dimension, family business governance additionally addresses the family's relationship to ownership and management. In a sense, a lot of family business literature has implicitly dealt with family business governance issues, because many writings have addressed aspects of relationships among the important stakeholders within the family business. For example, Donnelley (1964) observed in his classic article a potential conflict of interest between the family and the company, and how their respective interests can be balanced by constraining the family members' privilegies and by building on traditions.

Consequently, authors have emphasized that governance structures in family firms should cover both the business and the family in order to safeguard the long-term interests of shareholders (e.g., Lansberg, 1999). The governance of the business is normally accomplished by the board of directors, if at all. Families may organize themselves in order to promote communication and "enlightened ownership" (Neubauer & Lank, 1998). The structures within families have no specific format because they are not required to by law, but they are set up voluntarily by the family shareholders. One common structure within a family is the family council, which consists of a group of family members, and perhaps some members outside of the family, and which periodically comes together to discuss the family's relation to the business. Gersick et al. (1997) have given four important reasons to set up a family council: (1) educating family members about the rights and responsibilities associated with ownership and management, (2) helping to clarify the boundary between the business and the family, (3) providing the relatives means to focus on family business matters, and (4) helping to create a common understanding about the future of the family business. Success of family business governance is dependent on how well the work of different governance bodies, like the board of directors and the family council, is coordinated. This coordination is primarily brought about by senior leadership, overlapping membership, and structured communication (Gersick et al., 1997).

Governance of a family firm change over time. The family, business, and ownership all have their own lifecycle patterns, which are separate but linked. Building on Tagiuri & Davis' (1982) static family business system model and on various life-cycle models, Gersick et al. (1997) have presented a dynamic family business model that takes into account the different lifecycles of the family, business, and ownership dimensions as shown in Figure 3.3.

Each dimension of the developmental model has several stages. The business development dimension follows stages similar to those proposed earlier by Adizes (1979), who claimed that organizational development follows a bell shaped life-cycle from its birth to death, each passage having a different mix of success factors. The model by Gersick et al. is consistent with Greiner's (1972) growth model, which claimed that a company's development over time is not linear and smooth but is a process consisting of more stable "evolutionary" phases, followed by "revolutionary" transition periods between them. The ownership development dimension in the Gersick et al. model is very similar to Ward's (1991) earlier classification of family ownership into three subsequent stages, which he labeled as the founder(s), the sibling partnership, and the family dynasty stage. The family dimension of the Gersick et al. model addresses the individual and interpersonal developments within the family. The four stages describe how the roles and relationships among the senior and junior generations evolve as time passes. This dimension of the model applies work of Levinson, Darrow, Klein, Levinson & McKnee (1978) on the eras of the human life-cycle in a business family context.

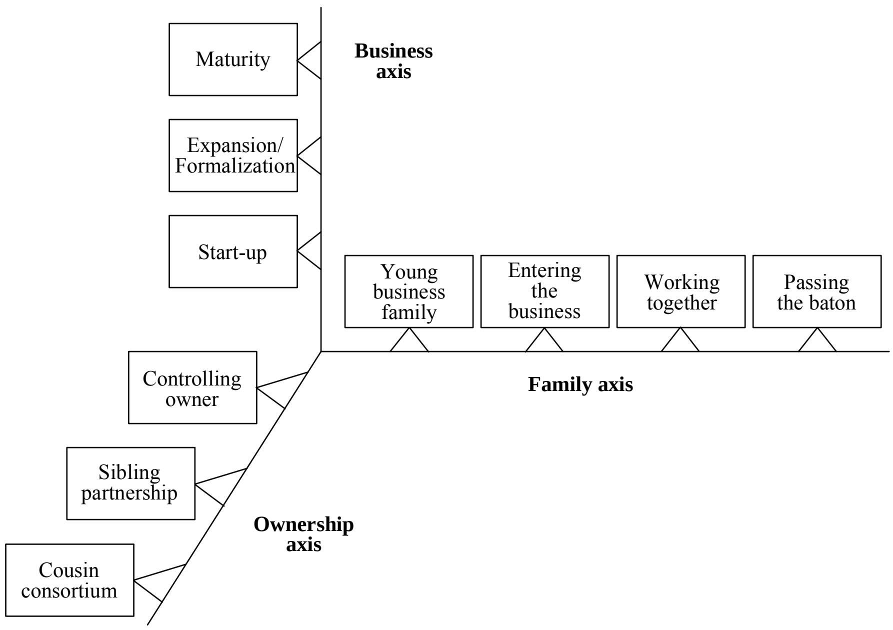

Figure 3.3 Developmental model of the family business (Gersick et al., 1997: 17)

Management succession can be considered as part of family business governance. For family business success and continuity, it is critical how management succession processes are planned and implemented. Literature on management succession is abundant. The following examples from literature characterize different facets of the succession process: model for succession planning in small businesses (McGivern, 1978), a research framework that has transfer of control as its anchor (Churchill & Hatten, 1987), lack of succession planning reduces survivability of family firms (Lansberg, 1988), effects of sibling attachment and rivalry on intergenerational succession (Friedman, 1991), quality of succession experience of next generation (Handler, 1989a), quality of work relationship between owner-manager and successor (Seymour, 1993), links between management succession and human resource policies (Welsch, 1993), role of human resource and governance practices in succession (Astrachan & Kolenko, 1994), family and non-family firms differ in successor development (Fiegener, Brown, Prince

& File, 1994), factors that differentiate effective successors from less effective (Goldberg, 1996), characterization of successors (Chrisman, Chua & Sharma, 1998), multi-level process model of family influences on succession (Davis & Harveston, 1998), and family relationship dynamics during ownership transitions (Dunn, 1999). Although management succession planning has been considered as critical to family business continuity, it may not address all the important aspects involved in succession. Aronoff (1998) has suggested that generational transition is replacing succession planning because it addresses a broader set of issues, including executive leadership and family leadership in a multigenerational context.

3.6 Conclusions of the literature review

This section presents conclusions of the literature review, focusing on three aspects. First, the distinctive challenge of the governance of family firms is discussed. Second, the two theoretical frameworks are contrasted to provide a better understanding of their special characteristics. And third, the question of how the two theoretical frameworks can be applied in the family business context is addressed. Literature on strategic decision making contributes to the modeling of the relationships between various governance mechanisms and strategic decision-making quality, and it is not further discussed in this concluding chapter.

3.6.1 Distinctive challenge of family firm governance

A major underlying assumption in this study is that effective family firm governance is founded on the unique characteristics of family business. Chapter 3.5.1 discussed the unique characteristics under five categories: (1) enduring exchanges among the family agents, (2) family members emotional attachment to their company, (3) potentially high level of conflict, (4) low mobility of shares, and (5) mixed self-interested and altruistic behaviors. These unique characteristics can be seen as manifestations of the systemic nature of family business, i.e. the overlapping domains of the family, ownership, and business.

Ultimately, family firm governance is concerned about the survival and success of a family business system over time. In essence, there are two conditions that need to be met in order to achieve this. First, the company must be managed so that it can compete in the ever-changing product markets of its chosen business. Second, the ownership control must remain in the hands of a given ownership group, i.e. the family. This dual governance goal distinguishes family firm governance from that of widely held public corporations, where the owners can easily sell their ownership stake and where they have no other role in the corporation.

It is not argued in this paper that family firms are generally more successful than non-family firms. Rather, the view presented here holds that the unique characteristics of family business can be the basis of its success as well as its failure. It is argued here that whether the unique characteristics lead to success or failure is largely determined by how the family firm is governed. Some unique characteristics may at the same time contribute both positively and negatively to firm outcomes. For example, low liquidity of shares is likely to lower the risk of a hostile takeover, thus contributing to longevity of a family firm. However, it also makes management's entrenchment easier, allowing agency problems to arise and continue without interruption. Long CEO tenures have indeed been observed in family companies (Beckhard & Dyer, 1983).

Table 3.3 provides examples of factors associated with success and failure in family firms. The table is not an exhaustive listing of all factors contributing to success or failure, but it aims at providing a good sample of issues found in the extant literature. As can be observed from Table 3.3, few factors explicitly address governance of family firms. However, several issues related, at least indirectly, to both relational and contractual governance can be identified. For example, the Table 3.3 indicates that fast verbal and nonverbal communication, together with shared identity and common languages, are related to success, while conflicts between key stakeholders and poorly defined roles and decision rights are associated with failure. The lack of factors explicitly addressing family firm governance and firm performance may reflect the fact that this research domain is still in its early phase.

Table 3.3 Factors associated with success and failure in family firms[a]

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	

[a] Factors are drawn and modified from four sources: Gersick et al. (1997), Kets De Vries (1996), Neubauer & Lank (1998), and Ward (1987).

Figure 3.4 summarizes the above discussion on the distinctive challenge of family firm governance. Factors contributing to success and failure are any factors that mediate the unique characteristics of family firm to governance outcomes in terms of some firm performance criteria and ownership control. It should be noted that desired levels of firm performance and ownership control are set by the owners and management, more or less explicitly, and that aspiration levels of the firm's performance are likely to vary from firm to firm.

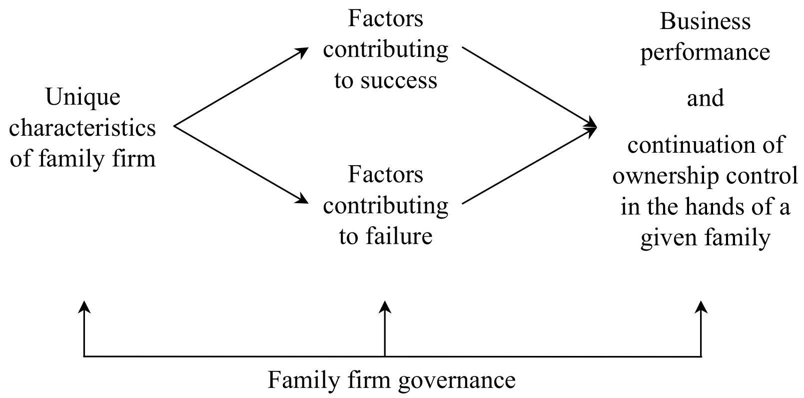

Figure 3.4 *Distinctive challenge of family firm governance*

The family firm governance framework, as depicted in figure 3.4, implies that family firm governance entails three broad sets of activities. It is proposed here that effective family firm governance is based on (1) a thorough understanding of the unique characteristics of the family firm under consideration, (2) targeting governance decisions and actions in such a way that strengthens factors contributing to success and alleviates factors having negative effects, and (3) defining the firm performance criteria and ownership control needs explicitly to provide follow-up criteria. In the light of the overall governance framework presented above, the purpose of the theoretical models, and the accompanied hypotheses, is to increase our current knowledge as to how various governance mechanisms, both formal and informal, can increase the chances of family firm success and survival.

3.6.2 Comparison of the agency theory and the social capital theory in the study of corporate governance

Agency theory and social capital theory have very different origins, assumptions, and prescriptions. Table 3.4 compares the basic elements and main critique of both frameworks.

Table 3.4 Comparison of the basic elements and main critique of the agency theory and the social capital theory

	Agency theory	Social capital theory
Theoretical origin	Neoclassical economics	Sociology
Concept of the firm	Nexus of contracts	Network of social relationships with strong ties
Behavioral assumptions	Self-interested, limitedly rational, and resourceful individuals	Norms of reciprocity and equity
Main critique	Atomized view of relationships; ignores ongoing systems of social relations	Emphasizes the positive effects of personal ties, while understates the negative consequences

Both the frameworks have been applied in a number of organizational studies. The agency theory has mainly focused on various governance studies while the social capital theory has addressed a broader range of research contexts. Table 3.5 compares the characteristics of the frameworks to the study of corporate governance. Agency theory is a well-established theoretical governance framework aiming at explaining how different forms of organizations survive by managing the trade-off between minimizing various agency costs and maximizing benefits of decentralized decision making. Social capital theory studies resources embedded in social relationships, focusing on how social resources are created, and subsequently converted, into other forms of capital, such as human and physical capital.

Table 3.5 Comparison of the agency theory and the social capital theory in the study of corporate governance

	Agency theory	Social capital theory
Nature of governance relationship	Asymmetric principal-agent relationship	Symmetric network or dyadic relationships
Goals of governance	Minimization of agency costs, while maximizing the benefits of decentralized decision making	Generation and acquisition of resources through social relationships
Nature of governance mechanisms	Contractual, formal control	Relational, informal control
Potential risk in governance	Focuses attention excessively to agency cost minimization, while ignoring value creation aspects	Group cohesion may cause inability to change
Position in corporate governance research	Well established framework	Emerging framework

3.6.3 Applicability of the agency theory and the social capital theory to the study of family firm governance

Agency theory perspective has been used in an increasing number of organizational studies and it has become a widely accepted theoretical framework. Finkelstein & D'Aveni (1994) argued that combining and contrasting agency theory with other frameworks rooted in sociology and psychology may provide new insights into organizational research. Because of its unique characteristics, a family business context seems to be a fruitful research context to combine aspects of agency theory and social capital theory. Both theories can potentially contribute to the understanding of the complex phenomenon of family firm governance, the agency theory shedding light on formal control, and the social capital theory contributing to the understanding of informal social control.

The agency theory provides a framework to analyze the effects of separation of ownership from managerial decision making. Although most governance research has been conducted in large public companies where ownership is almost completely separated from the firm's management, and owners have little connection to the firm (Gomez-Mejia et al., 2001), separation of ownership and management do also occur in family firms. When family companies grow larger, they start to resemble large public companies in some respects. The number of shareholders may increase, they may have hired, professional management, and they may have vigilant boards of directors overseeing the management (Lansberg, 1999). The separation processes are not necessary linear in family firms. For example, the ownership may consolidate again if some family members of the extended family buy out the other members from the company. However, growth of the family and ownership base, and the owners' decreasing participation in the firm's management, are natural tendencies in family businesses as they become older and larger. Consequently, the number of principal-agent relationships grows, and the risk of related agency problem increases.

Some researchers have claimed that the agency theory may not be directly applicable in a family business context, or that it may not provide full understanding about how family firms are governed. Large publicly held corporations have many safeguards to help preventing dysfunctional managerial behavior, while family firms do not necessarily have those safeguard in place (Kets De Vries, 1996). Dyer has even noted that "the assumptions underpinning agency theory may not be valid in family firms because relationships are based on familial bonds" (1994: 125). Aronoff & Ward (1995) have proposed that family firms may lack the advantages seen in publicly traded, large corporations, but on the other hand, they are not likely to have similar weaknesses. Also, Litz has noted that "while publicly traded firms have been noted to suffer from maladies of professional management..., little, if any, attention has been devoted to the unique dysfunctionalities experienced by firms influenced by a family agenda" (1997: 65). Finally, Schulze et al. (2001) suggested that family businesses might suffer from "owner opportunism," which cannot be explained by the agency theory. However, this dissertation claims that the agency theory is valid in the family business context, but it needs to be complemented with other theories. This is consistent with Fama & Jensen (1983b), who showed how the principles of the agency theory applies both in "open" corporations and "closed" corporations, leading, however, to different behavioral implications.

Rooted in social capital, a relational perspective should be especially relevant in family business governance because the relationships have strong social component. For example, trust among the family members and management has been considered as a factor important to family business success (Aronoff & Ward, 1995; Davis & Harveston, 1998; Dyer & Handler, 1994; Lansberg, 1999; Walsh, 1994). On the other hand, lack of trust within the family and family firm tend to destroy cooperation, and ultimately the viability of the family business (Cosier & Harvey, 1998; Kets De Vries 1996; LaShapelle & Barnes, 1998). Donnelley (1964) has suggested that a family firm's success or failure is more a function of the family members' relationships than the family participation as such. Although the family's commitment to the prosperity of the business can be a very positive force (Dyer & Handler, 1994), several authors have noted that there is a lack of research of influences of family and familial ties on the performance and survival of firms (Harvey, 1999a; Litz, 1997; Davis & Herrera, 1998). Litz has pointed out that "management researchers have committed the error of overlooking the role of tribal, and, more specifically, the familial, factors that characterize the vast majority of firms...and the apparent trust-based advantages...that appear more readily attainable by family firms" (1997: 66). Traditions, bonding relationships, loyalty, and norms of equality and altruism inherent within families will lengthen the perspective of the family business and define considerations as to how family resources are to be utilized (Harvey, 1999b).

In summary: the present dissertation applies both the agency theory and the social capital theory to its task of explaining the relationships between the owners and management of family firms. The two views are considered complementary approaches to family firm governance because they deal with different dimensions of the phenomenon. The agency theory addresses formal aspects of governance to control owner-manager relations, while the social capital theory addresses social resources generated through a network of social relationships among the family and management. By applying two different theoretical frameworks, the dissertation aims at obtaining a richer understanding about family firm governance.

4 THEORETICAL MODELS AND HYPOTHESES

The study's theoretical models and related hypotheses are developed in this section. First, an overview of the theoretical models is provided with an introduction to the strategic decision-making constructs used in models. Then, two models of family business governance, referred to in the study as the "contractual governance model" and the "relational governance model," respectively, are developed, and a hypothesis on the joint effects of the models is proposed. Next, the hypotheses on the relationships between the strategic decision-making constructs and firm performance are developed. The section concludes by summarizing the hypotheses.

4.1 Family firm governance framework

This study adopts the view that successful family firm governance addresses both governance of the business as well as governance of the family (e.g., Gersick et al., 1997; Lansberg, 1999). Inclusion of the family in the governance domain is important because family members may have multiple roles within the family business; familial ties are likely to affect exchange relationships between the owners and the company. Also, the owners' rather illiquid ownership stakes effectively prevent "exit-based" ownership strategies, and promote "voice-based" corporate control (Nooteboom, 1999). In exit-based control, owners have a short-term, market oriented relationship with the corporation, whereas voice-based corporate control features socially embedded, ongoing relationships between the owners and the firm, as is the case in family firms.

It was concluded earlier that agency theory largely ignores the effects of good social relationships that might exist among the key stakeholders in the family firm. The close social interactions between family members may be a source of competitive advantage, partly because informal, self-reinforcing governance mechanisms may complement the formal systems emphasized in agency theory. The theoretical models developed in this study are based on the assumptions that the agency theory is applicable in the family firm context, but better explanations can be reached if governance mechanisms directly addressing social forces also are included in theoretical models. Thus, the research models of this study comprise both contractual and relational governance mechanisms, mirroring descriptions of the agency theory and the social capital theory.

Contractual governance refers here to the characteristics and operations of the board of directors, which is at the top of the decision systems of organizations. Contractual governance systems can align the interests of owners and managers, promoting effective strategic decision making (Pearce & Zahra, 1991). The contractual governance model addresses how the ownership structure influences the membership composition of the board, and how this composition, in turn, affects two vital board functions: the board's oversight of management and its advice and counsel to management. *Relational governance* refers here to the creation and usage of social capital embedded in social relationships among the owner family members and management. The relational governance model benefits from several types of social capital. The central element in the relational model is social interaction, and its antecedents and consequences.

Corporate governance and strategic decision-making processes are closely related. According to the strategic choice perspective, a firm's top management has a decisive role in determining what strategic choices will be made (Child, 1972). Corporate governance is concerned with how different organizational forms and governance systems affect managerial decision making (Fama & Jensen, 1985). Decisions made by management do not always have desirable consequences for owners because interests of the owners and the management may differ. This can be expected to be the case in family firms too, depending on the degree to which the residuals claimants are also important decision agents, i.e. on the degree to which there is an overlap between ownership and management.

Both contractual and relational governance models employ the same set of dependent strategic decision-making variables. Because a strategic decision has "important consequences and resource demands for the organization" (Nutt, 1998: 198), the organizational performance depends on the quality of strategic decisions and how well these decisions are implemented (Dooley & Fryxell, 1999). *Decision quality* refers to the extent to which a decision contributes to the achievement of organizational goals. Effectively implementing decisions depends on a decision-making team's commitment to these decisions (Korsgaard et al., 1995). *Decision commitment* indicates the extent to which team members accept and commit to the strategic decisions reached (Korsgaard et al., 1995: 61). Extant family business literature has shown that success of family firms can greatly be affected, both negatively and positively, by the motivations and behaviors of the owner family members. Family members can, thus, greatly influence the strategic decision-making process in terms of its outcomes and implementation of decisions. Because of the family's potentially large impact, decision commitment will explicitly be modeled from both the management's perspective and the family's perspective. Collectively, decision quality and decision commitment are termed in this study *decision-making quality*.

Ultimately, strategy research is concerned with the link between the firm survival and strategic choices the firm makes, including for example, the selection of goals, the choice of products the firm offers, decisions as to how to compete, and choices on the scope of the firm's businesses. It is the integration of the strategic choices that makes a strategy (Teece et al., 1995). This study addresses the link between the strategy and survival by studying relationships between strategic decision-making quality and the overall firm performance, defined in terms of the firm's profitability and growth.

Figure 4.1 shows the theoretical models integrated and simplified. The contractual governance model addresses relationships between contractual governance and strategic decision-making quality constructs. Similarly, the relational governance model studies relationships among relational governance and strategic decision-making quality constructs. As suggested in Figure 4.1, and consistent with Granovetter (1985), the dissertation argues that relational governance complements contractual governance of family firms. In contractual and relational governance models, the strategic decision-making quality constructs act as dependent variables, while they are independent variables in the model focusing on the links between strategic decision-making quality and the firm's overall performance. The constructs shown in the Figure 4.1, and their hypothesized relationships, are elaborated in the subsequent chapters.

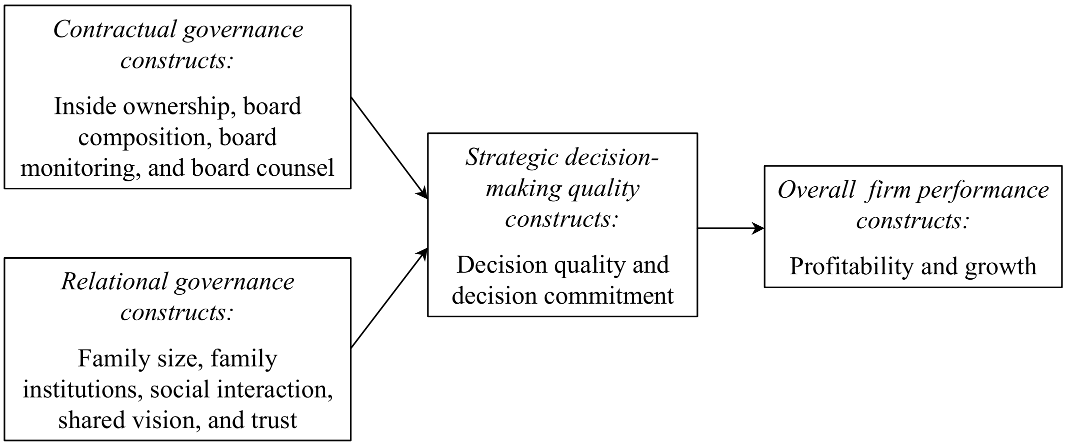

Figure 4.1 *Overview of theoretical models*

4.2 Contractual governance model

Governance research addresses the potential divergence of interests between owners and management because of the separation of ownership from control. Given individuals' bounded rationality, decision rights within an organization are delegated to the levels where they are best handled (Hayek, 1945; Simon, 1976). This process, however, creates agency problems because of managers' self-interests (Jensen & Meckling, 1976). Governance theorists, therefore, have identified several external and internal governance mechanisms that can protect shareholders against management's opportunism (Walsh & Seward, 1990). However, compared to large publicly held corporations, family-controlled corporations have different contractual characteristics. Their distinctive contractual nature has implications for contractually based governance mechanisms found in family firms. Accordingly, this section is divided into two parts. First, the contractual nature of family firms is discussed, and then the contractual governance model and associated hypotheses are developed.

4.2.1 Contractual nature of family firms

Different organizational forms have their special characteristics concerning how they delegate decision rights within the organization, and, consequently, incur agency problems. Agency theory posits that different organizational forms can survive in competition based on different sets of success factors; survival of a given organizational form depends on how specific advantages and disadvantages are governed (Fama & Jensen, 1983a). From an agency theory perspective, a “typical” family firm has concentrated ownership, considerable overlap between ownership and managerial control, and a lack of external control mechanisms such as a market for corporate control. However, these characteristics are not constant in family firms; they can, in fact, vary considerably. Consequently, effective modes of governance can be expected to vary among family firms.

As noted in the literature review, agency theory views a corporation as “a nexus of contracts,” where a set of written and unwritten contracts are coordinated with its exchange partners (Alchian & Demsetz, 1972; Jensen & Meckling, 1976). These contracts also specify rights and performance criteria of each agent in the organization. The central contracts in an organization specify the nature of residual claims, i.e. rights in net cash flows, and the allocation of decision rights (Fama & Jensen, 1983b). Residual claimants, who are the shareholders in a corporation, bear the financial risk of owning the stock in the hope of receiving the difference between the firm’s stochastic cash inflows and outflows. Fama & Jensen describe two types of corporations, “open corporation” and “closed corporation,” which both have distinctive contractual characteristics. Open corporations are typically large complex organizations, while closed corporations are smaller and less complex. Family firms fall somewhere between these two types. Table 4.1 compares characteristics of open and closed corporations, which can be thought of as serving the “conceptual ends” of a spectrum of family firms.

Table 4.1 Comparison of characteristics of open and closed corporations (Fama & Jensen, 1983a; 1983b)

Characteristic	Open corporation	Closed corporation
Nature of residual claims	Stockholders are not expected to have any other role in the company Residual claims are freely alienable	One or few residual claimants Alienability of residual claims is restricted
Factors contributing to organizational success	Residual risk is spread over many residual claimants Residual risk bearing and management are specialized functions Delegation of decision authority to agents who have relevant specific knowledge throughout the organization Capability to purchase large amounts of organization-specific risky assets Investment decisions are based on weighing current and future net cash flows according to opportunity cost	Residual claims are largely restricted to important decision agents; this has two beneficial implications: 1 Avoidance of agency problems because residual risk bearing is not separated from decision functions 2 Efficiency gains in decision processes due to simpler decision-making structure
General disadvantages	Agency problems caused by the separation of residual risk bearing from decision functions (i.e. separation of ownership from control) Costs of controlling agency problems; several external and internal governance mechanisms protect shareholders' interests	Efficiency losses because of non-specialized risk bearing and management functions Foregone diversification and limited alienability of stock lower the value of residual claims, raise the cost of capital, and lead to lower than optimal investment level

In Fama & Jensen's categorization, the majority of family firms appear to be closer to the definition of the closed corporation. However, many family firms are large and complex organizations, having, at least in part, freely alienable residual claims. Thus, some family firms resemble open corporations. This is exemplified by an estimate that 40% of the Fortune 500 companies are family controlled with a minimum of 10% ownership stake (Zeitling, 1976).

From a purely economic utility maximization point of view, agency problems are avoided when residual claimants act also as important decision agents. This situation aligns the interests of self-interested owners and managers, because they are same individuals. In addition to the pure economic-rational cause of agency problems, Jensen has identified "a second major source of agency costs, the costs incurred as a result the *self-control problems* (emphasis added)...that is, the actions that people take that harm themselves as well as those around them" (1998: 48). Jensen gave several examples of non-rational self-control problems. For example, people have a common reluctance to welcome feedback on their errors. Jensen argues that “clinical psychological records as well as everyday observations of family, organizational, and social action abound with examples of nonrational behavior” (1998: 45), and that this behavior should also be taken into account when analyzing agency problems.

As discussed earlier, family business literature is filled with anecdotal evidence of conflicts that plague them. Evidence also suggests that conflicts having an emotional origin are common in family businesses. This type of affective conflict is generally considered nonproductive (e.g., Amason, 1996). Recently, some authors have begun to explore more explicitly the qualities of agency relationships and their organizational consequences in a family firm context (Gomez-Mejia et al., 2001; Ling, 2001; Schulze et al., 2001). These studies argue that family firms do not fit well into the standard agency theory because of several family business specific “nonrational” characteristics. To summarize the above discussion concerning the nature of agency problems, it is assumed in this study that there are two broad types of agency problems in family firms: (1) agency problems related to stakeholders’ deviating interests due to separation of ownership and control, and (2) agency problems related to nonrational or seemingly nonrational behaviors.

Large publicly held corporations (open corporations) are controlled against managerial malfeasance by several external and internal mechanisms, whereas family firms rely mostly on internal governance mechanisms, if any, and only marginally on external control. Market for corporate control, i.e. the transferring of managerial control to new shareholders through acquisitions and divestitures (Hitt et al., 1996), is generally not available to family firms because the ownership of shares is restricted largely to the family and its close allies. By employing external entrenchment practices (Walsh & Seward, 1990), family firms may effectively influence the structure ownership and keep the ownership control in the hands of the family. The inefficient market for corporate control among family firms increases the shareholders’ risk and lowers the value of their assets, because the market for corporate control is considered as the shareholders’ last resort against bad managerial decision making and failing internal control systems (Fama, 1980). The stock market can also act as an external device monitoring large publicly held corporations, because stock prices reflect the implications of managerial decision making (Fama & Jensen, 1983b) for current and future cash flows. Although some family-controlled firms are publicly listed, the stock market is not a common external governance mechanism for family businesses.

However, large blockholders, like families, may act as a substitute control for the external market for corporate control and other external control mechanisms. Large blockholders usually have both the motivation and capability to monitor managerial decision making, which should decrease agency costs (Agrawal & Knoeber, 1996; Byrd, Parrino & Pritsch, 1998). However, the owner family's monitoring capabilities are likely to have more variation than those of other types of large blockholders.

Moreover, Cubbin & Leech (1983) argued that the separation of ownership and control affects in two related ways the possibilities of outside owners' controlling managerial behavior. First, the location of control, i.e. owner control versus managerial control, is determined by the extent that managers own shares. Second, the degree of control the outside owners (owners that are not managers) have over managers depends on how dispersed the outside ownership is, which, in turn, affects the probability of their winning votes and gaining voting power. Thus, large dispersion of outside ownership is related to weak owner control, whereas concentrated outside ownership contributes to strong control. In the light of the Cubbin & Leech model, family firms have potentially an excellent opportunity to exercise ownership control, because the family members' stockholdings tend to be concentrated by kinship ties. DeAngelo & DeAngelo supported this view when they noted that "implicit contracts, e.g., as among officers and their relatives, can also act to consolidate voting rights within a group" (1985: 50).

In widely held public corporations, the board of directors is "the common apex" of internal decision control systems (Fama & Jensen, 1983b). In that role, the board can, for example, hire and fire the CEO, and decide which strategic initiatives will be implemented. The role of the board has a broad variation between family firms. Neubauer & Lank (1998) classified the board's role in family firms into four categories, where (1) the board has little or no influence, (2) the board has a fiduciary role protecting family and shareholder interests, (3) the board has a decisive role in strategy setting, control, and hiring top executives, and (4) the board is in fact running the business. If compared to the role of the board in widely held public corporations, as normally understood, the first two board roles in the Neubauer & Lank categorization seem "under-involved," whereas the fourth role appears "over-involved" in terms of the board's participation in strategic decision making and in the day-to-day running of the business.

Agency theory suggests that boards of directors represent and protect the interests of owners by monitoring and controlling top management (Fama & Jensen, 1983b). In family businesses, however, this division of roles is easily blurred. Forbes & Milliken note "the board [of family firms] may simply have no control function in the conventional sense, because shareholders rights and managerial responsibilities will reside in the same persons" (1999: 501). This is especially true early in a company's life when ownership may reside in a single owner manager. Later, members of the extended family may serve on the board or in top management positions and share the controlling ownership (Gersick et al., 1997).

Many scholars believe that a board's independence, whether in large or small corporations, is undermined by the formal and informal power of the CEO (e.g., Galbraith, 1972; Lorsch & MacIver, 1989; Mace, 1972). Baysinger & Hoskisson noted "that managers dominate their boards by using their de facto power to select and compensate directors and exploiting personal ties with them" (1990:72). Pettigrew (1992) identified four explanations of the management's control over the board: (1) top management's control over the selection of directors, (2) the limited time outside directors have available for their duties, (3) top management's superior information about the firm's business, and (4) norms of board conduct limiting the outsiders' independence. The CEO of a family firm may even have more power vis-à-vis the board. The CEO's family ties and high ownership stake contribute to high CEO power. Additionally, CEO power is increased when the chair and CEO positions are held by the same individual, which is often the case in family firms. Figure 4.2 summarizes the discussion of the contractual nature of family firms.

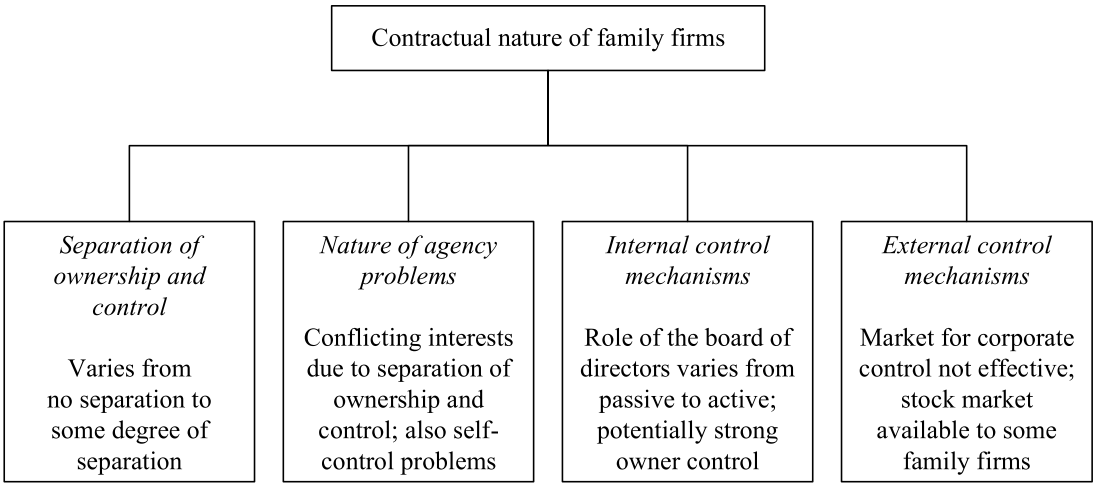

Figure 4.2 Contractual nature of family firms

4.2.2 Contractual governance mechanisms and strategic decision-making quality

This study follows some earlier governance studies as it integrates aspects of organizational-economics and strategic management literature (Baysinger & Hoskisson, 1990; Johnson, Hoskisson & Hitt, 1993). More specifically, agency theory provides a framework for understanding how the ownership structure is linked to board composition and board participation in decision processes, while strategic management literature contributes to views on how the board's activities affect managerial choices and their implementation. Both agency theory and the strategic choice approach emphasize the role of top executives in setting the strategic direction for a firm.

Vigilant boards are "believed to set premises of managerial decision making" (Baysinger & Hoskisson, 1990: 76). Board vigilance is commonly related to board independence. Previous research has found that board composition, in terms of the ratio of outside members to the total number of directors on the board, can serve as a proxy for board independence and vigilance (Daily, Johnson & Dalton, 1999).

Corporate governance literature has studied extensively activities of the boards of directors. The literature classifies the activities under two broad tasks: control and service tasks (e.g., Forbes & Milliken, 1999). Following agency theory, *control* centers on hiring, compensating, disciplining, and firing senior managers; approving top managers' initiatives; and evaluating senior managers' performance (Johnson et al., 1996). *Service* includes those activities that enhance a firm's reputation and competitiveness by giving advice and counsel to management, establishing links with the external environment, and representing the firm in the community. Directors' service roles support the company's strategic decision process (e.g., Zahra, 1990), which influences the firm's performance. In this study, *board monitoring* addresses parts of the board's control task, including monitoring of strategic decision making and financial outcomes; *board counsel* consists of those activities of the board's service task that involve advice and counsel in the strategic decision-making process.

Figure 4.3 illustrates the research model for contractual governance, reflecting the following four views: (1) the board of directors is the common apex of internal control systems, (2) ownership structure is an important determinant of board composition and its functions, and (3), the two vital board functions, board monitoring and board counsel, have consequences for strategic decision-making outcomes.

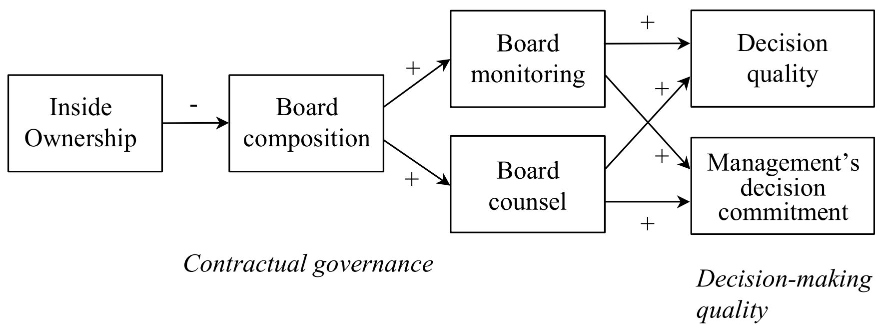

Figure 4.3 The contractual governance model

Ownership structure is an important determinant of managerial behavior in agency theory. In this study, the ownership structure is defined in terms of *inside ownership*, indicating the proportion of common stock held by family members who are either directors or officers of the family firm (Kesner, 1987; Luoma & Goodstein, 1999).

Inside ownership and Board Composition

Following agency theory, the composition of the board determines directors' independence from management and their ability to undertake their monitoring and service roles (Dalton, Johnson & Ellstrand, 1999). The representation of outside directors on the family firm's board is especially important. Outside directors are defined here as directors who are not from the family or from the family firm's management. Despite contradictory past findings about the link between the representation of outside directors and company performance (Dalton et al., 1999; Zahra & Pearce, 1989), agency theory suggests that increased outside directors' representation enables the boards to exercise its control (through monitoring) and service (via counsel) roles.

Despite their major potential contributions outside directors can make to the success of a family business, owner managers are often reluctant to recruit outside directors. Family owner managers value their independence (Johannisson & Huse, 2000), and are often unwilling to share their powers with other family members and outsiders. Family members may also be unwilling to involve outsiders in running their companies, because they worry about confidentiality and privacy, and are concerned about loss of control and autonomy (Gersick et al., 1997). Having outside directors join the company's board may upset long-standing emotional ties that bond the family, thereby causing conflict. Outsiders may not fully understand the culture that prevails in the firm and drives the decision-making process; they might challenge the core values that dominate the firm's decision-making process. These factors can undermine the emotional and political balance that exists in the family firm, forcing owners to hire outside directors only in cases of crises (Johannisson & Huse, 2000).

Agency theory posits that there is a relationship between the firm's ownership structure and delegation of decision rights. According to Fama & Jensen (1983b), the decision process has four broad phases: (1) *initiation*: generation of proposals for resource utilization, (2) *ratification*: choice of the decision initiatives to be implemented; (3) *implementation*: execution of ratified decisions, and (4) *monitoring*: measurement of the performance of decision agents and rewarding them. *Decision management* combines the initiation and implementation phases, whereas *decision control* combines the ratification and monitoring phases.

Fama & Jensen (1983b) proposed that decision control and decision management are separated, when residual risk bearing (ownership) is separated from decision management. And correspondingly, decision control and decision management are combined when residual claims are restricted to important decision agents. In large, diffusely-owned corporations, the independent board of directors is assumed to perform decision control functions (ratification and monitoring), whereas the management is assumed to handle decision management tasks (initiation and implementation). In family firms, the level of family executives' ownership stake varies from complete ownership to low or even no ownership, depending on the dispersion of common stock and the degree of the family members' participation in the board and management. Thus, it can be expected that the degree of separation of decision control and decision management varies accordingly. The proportion of outside directors on the board has been used as a proxy of board independence (Johnson et al., 1996), which reflects the degree of the separation of decision control and decision management.

> **Hypothesis 1.** The higher the proportion of the family's inside ownership of the firm, the lower is the proportion of outside directors on the board.

Composition of the board of directors and board monitoring

The composition of the board of directors has been judged to be critical in corporate governance, including family firms (e.g., Ward, 1991). Outside directors are expected to be well aligned with the interests of the owners, whereas inside directors usually have better information about the firm's operations but are less independent (Johnson et al., 1993).

According to organization theory, drawing inferences about the performance of organizational actors may be based on two types of observations: monitoring their behavior or monitoring observable outputs as thought to result from their behavior (e.g., Eisenhardt, 1995). Also, the relationship between the strategic planning process and a firm's financial performance is "tenuous" due to complexity of planning-performance links and the many contingencies that can affect implementation of the strategy (Pearce, Freeman &

Robinson, 1987). Consistent with the organization theory's classification of control into behavior control and output control, Baysinger & Hoskisson (1990) proposed two board level controls, which they termed "strategic controls" and "financial controls." *Strategic controls* entail largely subjective, strategically relevant long-term criteria, while *financial controls* involve objective criteria such as return on investment (Hitt et al., 1996). The board monitoring construct in this study addresses both types of controls of top management.

Agency theory posits that ownership aligns the interests of managers and the firm (Fama & Jensen, 1983b). This alignment is conducive to shareholders' value maximization. However, although family ownership might align the interests of owners with the company, it also gives owner managers a free hand in running the firm in ways that can reduce efficiency and profitability. Owner managers may hire their relatives who are less qualified than other candidates. Indeed, nepotism is common in family business firms (Kets de Vries, 1996), where a job may be considered a birthright of a family member (Dunn, 1995). Further, owner managers may resist adaptation to environmental changes, putting their firm's survival at risk. Owner managers may act opportunistically because they are insulated from open competition for superior managerial talent (Schulze et al., 2001). Managers may also fail to train or select successors, leave conflicts among family members unresolved, or simply fail to develop long-term strategies for their companies. These problems are exacerbated by the entrenchment of family business managers (Gomez-Mejia et al., 2001). Outside directors can play a critical role in monitoring senior managers (Dalton et al., 1999).

Though inside board members (i.e. directors that are also managers) have more knowledge of the firm's operations, they are usually dependent on top executives for their jobs and may thus be less willing to challenge CEOs (Baysinger & Hoskisson, 1990). In contrast, outside directors will be more independent from management's influence and more vigilant in monitoring executives (Fama, 1980; Johnson et al., 1993). Further, because outside directors are often managers or directors of other companies, they are motivated to protect their reputations as professional directors by acting independently from top management (Finkelstein & D'Aveni, 1994). Outside directors, therefore, monitor top managers and ensure that shareholders' interests are protected (Fama & Jensen, 1983b). Also, the more there are outside members on the board of directors, the clearer the separation of ownership from management should be, and the clearer the monitoring function of the board should be. These directors play an important role in firing and replacing CEOs, and in strategy formulation and evaluation of prior strategies (Johnson et al., 1993; Judge & Zeithaml, 1992). Effective monitoring is evidenced in management's support of, and investment in, long-term value creating activities such as innovation.

> **Hypothesis 2.** The higher the proportion of outside directors on a family firm's board, the higher is the board's monitoring on top management.

Composition of the board of directors and board counsel

The agency theory has identified control over management as the board's primary function, while the board's potential role in providing advice and counsel to management has gained less attention. For example, while acknowledging the importance of a control component of corporate governance, Prahalad called for "a more constructive, value-adding relationship between management and investors" (1997: 55). However, the counsel role of the board is consistent with the agency theory. Fama & Jensen (1983b) noted that outside board members may have relevant complementary knowledge on a number of issues, and they can act as arbiters in disagreements among managers. Literature suggests that board involvement is increasing in all phases of the strategic planning process (Johnson et al., 1996; Tashakori & Boulton, 1985; Zahra, 1990). Judge & Zeithaml (1992) found in an empirical study that increased outside directors' representation on the board promotes active involvement in strategy formation and evaluation stages, addressing aspects of both decision control and decision management (Fama & Jensen, 1983b).

This study suggests a positive relationship between the proportion of outside directors and their counsel and advice role. Outside board members have a wealth of experience and diversity of backgrounds that allows them to provide advice and counsel to management (e.g., Zahra & Pearce, 1989). These directors view "their normal duty" as providing advice and counsel to the CEO (Lorsch & MacIver, 1989). This information can improve strategic decision making by exposing managers to fresh ideas and multiple perspectives that do not exist with the management team, thereby helping them discover new business directions. They may also act as “sounding boards” for the owner managers by listening to executives’ ideas and offering feedback (Ward, 1991), and by asking them “vital, but uncomfortable, questions which only the executive team could answer” (Cadbury, 1995: 47). Outside directors’ established business networks and relationships also connect owner managers to external information sources (Pfeffer & Salancik, 1978), further widening their access to data about industry conditions and potential competitive moves.

The board’s service tasks may have an added importance in family firms, because they are usually relatively small, and thus have a lack of resources and systems in place to analyze their industries on a formal and ongoing basis (Daily & Dalton, 1993; Fiegener, Brown, Dreux & Dennis, 2000; Forbes & Milliken, 1999). Further, Whisler (1988) emphasized the value of outside members for “threshold” family firms, companies that experience their first growth-induced crisis. Also, outside presentation on the board is likely to be associated with high “effort norms,” inducing active board discussions, and increased effort by individual board members (Forbes & Milliken, 1999). Having more outside directors on the board also increases the professionalization of the firm’s management (Daily & Dalton, 1993) through the advice and counsel directors offer senior executives. Mace summarized this by noting “the primary function of the outside directors is to provide a source of advice and counsel to the family owner-managers” (1972: 44). Additionally, a board with outside members can be a resource to the family business by balancing emotional conflicts (Ward, 1991), by counseling family members directly (Lansberg, 1999), and by supporting generational succession (Brunninge & Nordqvist, 2001).

> **Hypothesis 3.** The higher the proportion of outside directors on a family firm’s board, the higher is the level of the board’s counsel to top management.

Board Monitoring and Decision Quality

The agency theory posits that the potential divergence of interests among a firm’s owners and managers may lead to sub-optimal decisions and undermine shareholders’ value by incurring residual losses (Fama & Jensen, 1983a; Jensen & Meckling, 1976). Residual losses are opportunity losses due to bad strategic choices, which affect the firm's resource allocation, cash flow generation, and ultimately the firm value. Agency costs associated with bad decisions can be reduced by increasing control or by reducing deviating interests by increasing incentive alignment (Jensen & Meckling, 1976). The highest level of control in corporations with dispersed ownership is exercised by the board of directors as it is the "common apex" of the decision control systems (Fama & Jensen, 1983b). Board monitoring can alleviate these problems by improving the quality of the company's strategic decisions and thereby its performance. Although the board may have a limited control function in smaller, owner-managed firms (Forbes & Milliken, 1999), many family firms with more dispersed ownership are likely to benefit from board monitoring. Thus, it can be expected that the quality of strategic decisions in family firms will improve as the board monitoring activities increase.

Managers' firm-specific knowledge, which is often superior to that of the owners, is an important power source for managers, allowing them to pursue their own preferences. Such information asymmetry contributes to moral hazard, manifested in managerial decisions that are inconsistent with owners' interests (Gomez-Mejia et al., 2001; Zajac & Westphal, 1994). Increased monitoring of managers reduces this information asymmetry, and thus, the likelihood of moral hazard.

Also, the managers and owners may have different attitudes toward risk taking. In larger corporations with dispersed ownership, managers are likely to be more risk averse than the owners because the owners can easily diversify their risk across many firms while the human capital of managers is generally employed in a single company (Fama & Jensen, 1983a). Without an effective system to monitor decisions, managers tend to reduce their exposure to risks by selecting less risky and less profitable investment alternatives (Baysinger & Hoskisson, 1990). This may happen in family firms also, especially when the common stock is dispersed among a large number of extended family members and other types of owners.

A specific instance where the board involvement may radically affect the quality of decisions is during organizational decline. Previous research indicates that adversity can lead to organizational rigidities, such as resistance to change, reliance on past policies, and increased formalization (Daily & Dalton, 1994; Singh, 1986). Daily & Dalton (1994) found that independent boards with active control in a turnaround situation improves decision making and increases the chances of survival.

> **Hypothesis 4.** The higher the board's monitoring of top management, the better is the strategic decision quality in the family firm.

Board monitoring and decision commitment

The nature of top management's commitment to the chosen strategy varies greatly in family firms. In owner-managed companies, the top executives' and the shareholders' interests are automatically aligned to the degree to which the executives hold the company's common stock (Fama & Jensen, 1983b). Forbes & Milliken even noted that "in owner-managed firms the board may simply have no control function in the conventional sense, because shareholder rights and managerial responsibilities will reside in the same persons" (1999: 501). This implies high commitment to strategic decisions in owner-managed family firms, regardless of the amount of board monitoring activities. Although the boards of closely-held companies lack control power over management, some owner-managed firms see boards with outside directors helpful in providing unbiased views and forcing management accountability (Schwartz & Barnes, 1991).

On the other hand, in family firms where the ownership risk and managerial decision making are separated to a large extent, the board's monitoring of the managerial decision function becomes more effective. As discussed earlier, a board's monitoring activities are expected to reduce bad managerial decision making due to deviating preferences between the owners and management. Because managerial rewards are often tied to firm performance, increased monitoring should motivate the management to implement strategic decisions well. This should promote a positive attitude on monitoring (Baysinger & Hoskisson, 1990), thus increasing management's commitment to strategic choices.

The board's active and vigilant follow-up of the implementation of ratified strategic decisions signals the directors' commitment to the successful implementation of the firm's chosen strategy. Also, the board may make public statements, for example, in annual reports, about the firm's new strategic direction. All this is likely to create expectations throughout the company and its constituencies. The board's visible commitment to strategic decisions, combined with widespread social expectations, gives the management an additional incentive to implement decisions well (Janis, 1989; Zajac & Westphal, 1994).

Recognition of their decisions as the subject to the board's critical analysis and review is likely to promote interest of executives in evaluating their firm's systems and operating procedures and ensure these fit in with their proposed strategy. Monitoring by directors also increases willingness of executives to involve lower ranking managers and employees in the strategic decision-making process and to build support for their initiatives. Subordinates' front-end participation enhances their commitment to the resulting strategy and eases its successful implementation (Wooldridge & Floyd, 1990). Thus, monitoring motivates executives to plan the successful implementation of the proposed strategy.

> **Hypothesis 5.** The higher the board's monitoring on top management, the higher is the top management's decision commitment in the family firm.

Board Counsel and Decision Quality

The strategic decision process is challenging to its participants because the strategic choices determine how effectively corporate resources will be used, and because the strategic problems are complex and non-routine (Mintzberg et al., 1976; Nutt, 1998). Because of the importance and multifaceted nature of the strategic decision-making task, theorists have found that information-processing capabilities are imperative in the strategic decision processes. Much of the work in strategic management literature is induced by Ashby's (1959) requisite variety theorem, which implies that variety in a system's environment can only be controlled by variety in the system's outcomes. Ansoff, for example, restated the requisite variety theorem in business terminology by noting "for a successful response to the environment the complexity and speed of the firm's response must match the complexity and speed of the environmental challenges" (1984:

27). It is argued here that counsel provided by the boards of directors improves information processing capabilities during strategic decision making, and thus the strategic decision quality.

Literature on conflict and decision making has shown that there are two different types of conflict that have a bearing on the effectiveness of group decision making, namely cognitive conflict and affective conflict (Amason, 1996; Jehn, 1997; Priem, Harrison & Muir, 1995). Cognitive conflict refers to depersonalized, task oriented conflict, and it focuses on judgmental differences between decision alternatives, while affective conflict is conflict involving interpersonal relations, and it tends to focus on emotionally based personal disputes. Cognitive conflict is generally considered functional to group decision making because it provides "an amount and variety of information that match the complexity and uncertainty of the strategic decision-making task" (Dooley & Fryxell, 1999: 390). On the contrary, affective conflict is considered detrimental to decision making because it diverts the attention from the decision task to interpersonal issues.

Cognitive capabilities are related to the cognitive diversity within the group (Amason, 1996; Dooley & Fryxell, 1999). Thus, board counsel to senior managers can induce cognitive conflicts that compel executives to effectively assess alternative courses of action, increase the diversity of knowledge inputs into the company's decision process, and reduce information asymmetries that exist between managers and directors.

Cognitive conflict also improves decision quality because the synthesis emerging from diverse perspectives is generally superior to the individual perspectives (Amason, 1997). Outside directors' presence on the board can enhance this diversity. Outside directors, who encourage open discussion, inquiry and debate, can promote informed board involvement in strategic decision-making (Westphal, 1999). Schweiger et al. (1986) found that programmed conflict, using "dialectical inquiry" and "devil's advocacy," generates significantly better quality decisions than consensus decision making. Consistent with these arguments, Pearce & Zahra (1991) reported that active board participation in a firm's strategic decision-making process was associated with superior financial performance. These observations suggest a positive relationship between directors' counsel and advice and decision quality.

Hypothesis 6. The higher the board's counsel to top management, the better is the strategic decision quality in the family firm.

Board Counsel and Decision Commitment

Not only does board counsel improve decision quality, the process itself leads to increased commitment by top management to the resulting strategic decisions. Board counsel for top management on strategy increases and intensifies senior managers' participation in the strategic process. It also increases their examination of different strategic options and their implications for the family firm's competitive and financial position. This involvement increases participants' acceptance of the resulting decisions because it gives them an opportunity to discuss different perspectives during the decision-making process (Priem et al., 1995b; Wooldridge & Floyd, 1990).

Further, the involvement increases participants' commitment to the resulting decisions because it gives them an opportunity to "exercise voice" in the decision process (Amason, 1996: 128). More generally, engagement in decision processes results in increases in participants' "procedural justice" judgments, leading to improved commitment to decisions, increased voluntary cooperation, and ultimately, more successful implementation of the strategic decisions (Kim & Mauborgne, 1998; Korsgaard et al. 1995; Lind & Tyler, 1988). *Procedural justice* refers to "the extent to which the dynamics of the decision process are judged to be fair" (Kim & Mauborgne, 1998: 325).

An intensive process of board counsel and deliberation also instills positive, cognitive conflict within the company, as discussed earlier. These conflicts can increase the commitment of all participants to the decisions made. In family firms, participants in the decision-making process usually have common bonds that often allow them to work collaboratively through conflicts. Although the risk of affective, disruptive conflict is high in family business (e.g., Kets De Vries, 1996), cognitive conflicts present an opportunity for family firms. As Cosier & Harvey noted, "in a family business setting, merely raising the awareness that the disagreement inherent in process conflict can be positive may promote collaboration. Reminders that prevent process conflict from becoming relationship conflict should be frequent" (1998: 77). Getting through these conflicts should increase commitment to the resulting decisions.

Increased board counsel should also increase the options being considered. Research on escalation of commitment has shown that when there are more options under consideration, the psychological stake in any one strategic option is significantly reduced (Eisenhardt, 1989b; Staw, 1981). This makes it easier for senior managers to change their positions on different strategic alternatives in favor of the option(s) to which they are willing to commit themselves.

> **Hypothesis 7.** The higher the board's counsel to top management, the higher is the top management's decision commitment in the family firm.

Mediating effects in the contractual governance model

The above hypotheses has linked inside ownership with board composition and board composition with two vital board functions, namely board monitoring and board composition. Also, these board functions were directly linked to decision quality and management's decision commitment. Additionally, the contractual governance model shown in Figure 4.3 suggests several indirect relationships among the variables. While inside ownership is associated with less vigilant board activity, in terms of board monitoring and board counsel, it is the board composition that converts low inside ownership into active board monitoring and board counsel.

> **Hypothesis 8.** Board composition mediates the effects of inside ownership on board monitoring and on board counsel.

While it is proposed that board composition is related to a firm's strategic decision making, it is the board monitoring and board counsel that converts board composition into strategic decision-making quality.

Hypothesis 9. Board monitoring and board counsel mediate the effects of board composition on strategic decision quality and management's decision commitment.

4.3 Relational governance model

To date, governance-related studies using a social capital framework have mainly focused on inter-organizational relationships (e.g., Larson, 1992; Nahapiet & Ghoshal, 1998; Yli-Renko, Autio & Sapienza, 2001). This dissertation extends the analysis of social capital to the study of corporate governance, especially in family firm contexts. While the previous section focused on the influences of contractual governance on strategic decision making, this section addresses mechanisms of relational governance, and their effects on strategic decision making. Relational governance is concerned about informal, social control that regulates the relationships among the stakeholders, and it is induced by resources embedded in social relationships. This section is divided into two parts. The first part discusses social capital in family firms, and constructs used in the relational governance model. The second part develops the model and associated hypotheses.

4.3.1 Social capital in family firms

In family businesses, social relationships are usually strong and long lasting. Strength of relationships is amplified due to familial ties and family members' multiple roles in the firm. Traditions, bonding relationships, loyalty, and altruism determine how resources are used to create value for owners of family firms (Harvey, 1999a). Harvey also observed that "the key features of the family system that usually have the greatest influence on the operation of the firm are preexisting, implicit, social ties among family members" (1999a: 61). Thus, relational governance, which builds on social capital induced by strong ties within the family business system, is likely to have a high level of importance to success in family firms.

Earlier literature suggests that social controls may act as self-enforcing governance mechanisms in an exchange relationships (Dyer & Singh, 1998). Some aspects of social capital, such as trust (e.g., Ring & Van de Ven, 1992; Uzzi, 1996; Zaheer & Venkatraman, 1995), organizational reputation (e.g., Jones et al., 1997; Larson, 1992), and associability with an organization through collective goals and values, and shared vision (e.g., Leana & Van Buren, 1999; Ouchi, 1980; Tsai & Ghoshal, 1998), can serve as a governance mechanism.

The relational governance model presented in this dissertation employs five aspects of social capital in family firms, as shown in Figure 4.4. The five forms of social capital are classified according to Nahapiet & Ghoshal (1998) under structural, relational, and cognitive dimensions. The structural dimension addresses characteristics of the network of relationships as a whole, while the relational dimension is concerned about assets that are generated through personal relationships (Granovetter, 1992; Nahapiet & Ghoshal, 1998). The cognitive dimension deals with resources that provide shared interpretations and language among parties (Nahapiet & Ghoshal, 1998).

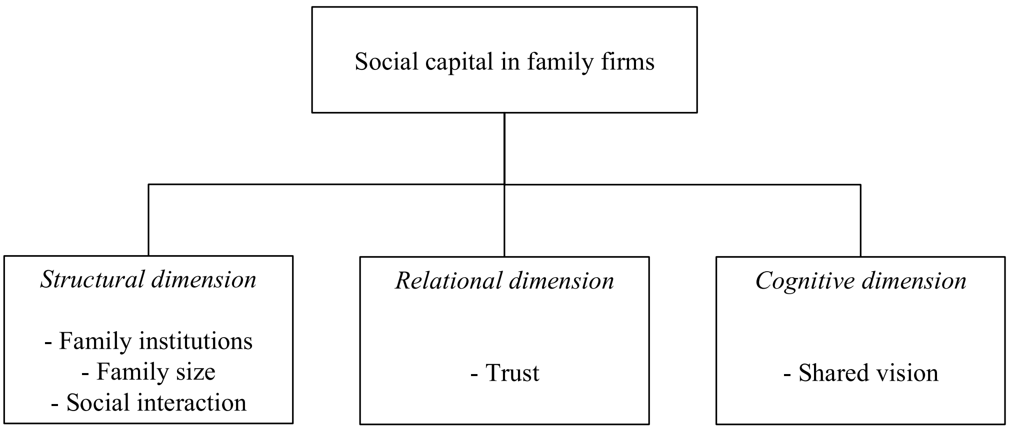

Figure 4.4 Social capital in family firms

The structural dimension of social capital in the model includes three constructs: family institutions, family size, and social interaction. *Family institutions* refers to informal and formal structures and processes within the owner family, such as family meetings and family councils. In this study, the family institutions construct addresses the number of qualitatively different family institutions used by a family. *Family size* refers to the number of individuals in the owner family, and *social interaction* refers to the level of personal and social ties among the owner family members.

The relational dimension of social capital in this study focuses on trust between the owner family members and management. Because there is no commonly agreed definition of trust among scholars, the concept of trust is briefly discussed and defined below. Following earlier trust researchers, Bigley & Pearce (1998) proposed that "actor vulnerability" could be a common theme to otherwise diverse trust literature. Trust as "willingness to be vulnerable" attaches the notion of risk to the concept of trust. Being vulnerable in a trusting relationship means that potential loss exceeds potential gain (Zand, 1972; Mishra, 1996). The trusting party is willing to be vulnerable to the extent it believes the trusted party will act as expected. In the recent literature, trust has been found to be a multidimensional construct. For example, trust has been divided into cognitive, emotional, and behavioral components (Mishra 1996, Cummings & Bromiley, 1996). The present study adopts Cummings & Bromiley's definition of *trust* as "as an individual's belief or a common belief among a group of individuals that another individual or group (a) makes a good-faith efforts to behave in accordance with any commitments both explicit or implicit, (b) is honest in whatever negotiations preceded such commitments, and (c) does not take excessive advantage of another even when the opportunity is available" (1996: 303).

The cognitive dimension of social capital in this study addresses a shared vision among the owner family members. A *shared vision* embodies the owner family's collective goals and aspirations concerning their firm, addressing the continuity of the company under the control of a given family. A shared vision may include some broad descriptions of desired business domains, desired growth rates, and financial performance. In short, shared vision denotes the family members' collective idea about the future of the family firm. The shared vision helps the family members to understand common long-term goals and proper ways of acting in a family business system (Tsai & Ghoshal, 1998). Thus, a shared vision promotes cohesiveness and group action.

The elements of social capital used in the relational governance model primarily focus on social capital within the owner family. In addition to being owners, the family members may serve as directors or as officers in the company. Thus, it is likely that high social capital within the family will result in high social capital among the top executives.

The only social capital construct where management is explicitly modeled is the trust between the family and management.

4.3.2 Relational governance mechanisms and strategic decision-making quality

Notions of social capital and strategic management are rarely explicitly connected, even though various social aspects of organizations have been linked to their strategies. For example, Rumelt et al. (1995) did not address social capital when they identified streams of "organizational sociology" literature that has contributed to strategic management research, namely resource dependence, organization ecology, and so called "new institutionalism" (Powell & DiMaggio, 1991). However, there is an increasing awareness that social capital and strategic decision making may be related. For example, Eisenhardt & Zbarachi noted that "strategic decision makers resolve conflict...also by developing cooperative decision styles, building trust, maintaining equity, and evoking humor" (1992: 34).

Social capital theory is consistent with the resource-based theory of strategy, which emphasizes the role of unique, firm specific resources in creating sustained competitive advantage (Penrose, 1959; Wernerfelt, 1984). Barney (1991) claimed that some resources are difficult to imitate by competitors because the resources may be socially complex, as is the case with the interpersonal relations among managers. Drawing from the resource-based view, Nahapiet & Ghoshal (1998) suggested that differences in firm performance might reflect differences in the firms' ability to create and exploit social capital. Using the social capital framework suggested by Nahapiet & Ghoshal (1998), Tsai & Ghoshal (1998) proposed and tested a model linking different dimensions of social capital and value creation in terms of a firm's product innovativeness. The relational governance model of this dissertation studies in much the same way the relationships among different aspects of social capital and their effect on the decision-making quality in family firms.

The research model for relational governance, as illustrated in Figure 4.5, is based on three views: (1) social interaction between the owner family members is a major factor in creating other forms of social capital, namely shared vision and trust, representing the cognitive and relational dimensions of social capital, respectively, (2) social interaction, representing the structural dimension of social capital, is largely determined by social processes and structures, and the size of the owner family itself, (3) shared vision and trust are direct determinants of decision-making quality, addressing decision quality and decision commitment within the management and the family.

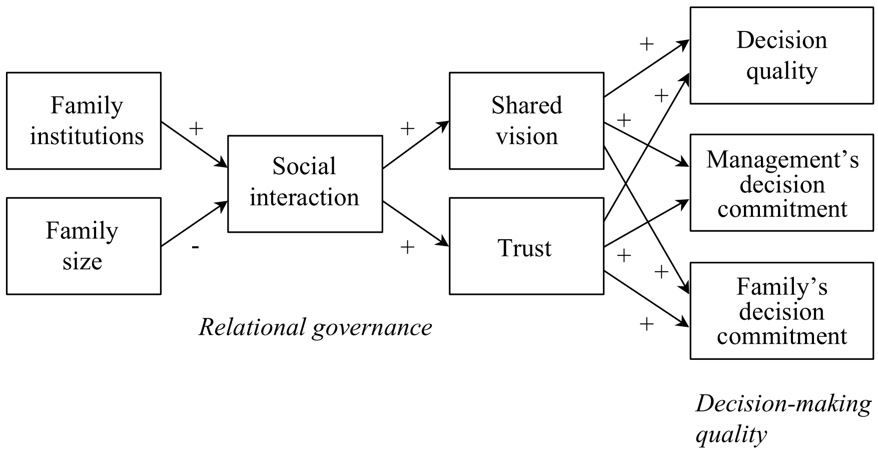

Figure 4.5 *The relational governance model*

Family Institutions and Social Interaction

Changes in family institutions can affect the formation of social capital within a family business. Gilding (2000) noted that new family structures, increased individual autonomy, and democratization among family members have led to more open ended personal values and decreased solidarity among the family members. Like many other authors, Gilding proposed that "new family institutions," such as family councils, could contribute the restoration of trust and communication within the families. For example, Habbershon & Astrachan (1997) found in an empirical study that "collective encounters," i.e. family meetings, contribute to create shared beliefs, which represent the cognitive dimension of social capital.

Family business governance addresses multiple relationships among the family, owners, and company management (e.g., Tagiuri & Davis, 1992; Lansberg, 1999). Thus, an important governance role is assigned to family institutions, or family systems and processes that are intended to facilitate the family's links with ownership and business (Montemerlo, 2000; Neubauer & Lank, 1998). Neubauer & Lank pointed out that family institutions "range from highly informal to formal bodies, and of course tend to vary over time and in parallel with the family's life cycle, the ownership stage and the life cycle of the business" (1998: 80).

A variety of family institutions have been identified in the family business literature (e.g., Gersick et al., 1997; Lansberg, 1999; Neubauer & Lank, 1998; Ward, 1987). In smaller families, governance may be based on *informal get-togethers*, often on a daily basis (Neubauer & Lank, 1998). As the owner family grows, *formal family meetings* bring together the family members to discuss issues of mutual interest. Some families use *family councils* as a representative body of the family. Other families draft *family plans* that define the family's vision about the future of the business and rules for family members' participation in the business.

The various family institutions discussed above perpetuate the family's active ownership and control of the firm. They also represent and integrate the needs and interests of the owner family members and link the family and the company. Family institutions also promote social interaction and cohesion among the owner family members, enabling other forms of social capital (e.g., shared vision) to develop. These institutions also create opportunities for family members to meet and discuss issues, further leading to increased interactions among members of the owner family. It can be expected that at any given point of time, a family business has a certain combination of different family institutions, reflecting the developmental phase of the family business system. It is argued here that each family institution adds a level of social interaction because family institutions address different aspects of links between the family and business, and involve different combinations of family members.

> **Hypothesis 10.** The higher the variety of family institutions, the higher is the level of social interaction among the owner family members.

Size of the family and social interaction

The family is tied together by the interpersonal relationships among family members both horizontally across the family and vertically over succeeding generations. Strong social ties among the family members "allow dilemmas of collective action to be resolved" (Putnam, 1995: 67), they ensure the effectiveness of norms that help to achieve positive effects of social capital and constrain dysfunctional behavior (Coleman, 1990). Tie strength is further increased if the same people are linked together via multiple overlapping roles. These dense relationships are sometimes called "multiplex" networks (Boissevain, 1974; Portes, 1998). Family businesses often involve multiplex networks, because family members may participate in the family business system via multiple roles, both within the family and in the business.

As the owner family grows larger, natural occasions for interaction diminish because the social ties between family branches are weaker and fewer than within the branches (Gersick et al. 1997), and it is more difficult for the extended family members to reach each others (Dubini & Aldrich, 1991). Similarly, Davis & Herrera noted that cohesion of the family is difficult to maintain because "at every ownership stage, the physical proximity and the ease and frequency of interaction of family shareholders affects the flow of information" (1998: 255), and that "familial ties are generally weaker in larger families" (1998: 258). Further, the family's participation in the business is likely to be relatively less in bigger families, contributing to further attenuation of social relations within the family. Also, organizational studies in contexts other than the family business have shown that group size is negatively related with the interaction between individual members (Judge & Zeithaml, 1992).

> **Hypothesis 11.** The bigger the owner family of the family firm, the lower is the level of social interaction among the family members.

Social Interaction and Shared Vision

As discussed earlier, shared vision refers to a family's members' collective idea about the future of the firm, or a shared "reasonable clear image of a desired future" (Leavitt, 1986: 62). In a family business, a shared vision centers on the continuity of the company under the control of the family. This vision usually includes broad descriptions of desired business domains, desired growth rates, and financial performance (Collins & Porras, 1996). Due to their extended ownership horizon, family business owners have strong incentives to see that their resources are used efficiently (Harvey, 1999b). Harvey suggested that family relations and family members' "reciprocal involvement" contributes to creating shared visions that foster long-term value creation. Effective family leadership is able to convey and transform the founder's original vision into a shared vision among the succeeding generations (Hoy & Verser, 1994). Further, social interaction facilitates family members' collective learning and development of "shared cognitive schemas" (Kogut & Zander, 1996).

Family businesses are characterized by intense interactions among family members and between the family and management. These interactions facilitate intense information exchanges that promote cohesion among family members, enabling them to forge a shared view of the goals of the family business. Also, family meetings contribute to expressing shared beliefs (Habbershon & Astrachan, 1997). Further, Aronoff (1998) argued that family ownership is becoming less autocratic, and more a team effort, enabling family members to participate in formulating ownership goals. These claims are supported by the literature in social psychology, which indicate that interaction among people tends to increase their similarity in attitudes and opinions (Brown, 1986; Vroom & Yetton, 1973).

Nahapiet & Ghoshal (1998) suggested that ongoing interactions create a shared language and collective narratives that provide a common basis for shared cognition, which is important under conditions of uncertainty and complexity. These conditions are characteristic of ongoing conversations about a family firm's strategy and future. Shared vision develops incrementally, with repeated interactions as parties learn about each other (Yli-Renko et al., 2001). These factors indicate a positive association between social interaction and shared vision.

> **Hypothesis 12.** The higher the level of social interaction among the family members, the greater is the shared vision among the owner family.

Social interaction and trust

Social interaction in family firms is amplified by the interacting domains of the family and business. Trust formation is clearly important in such a setting, because trust can be seen both as a cause to and a result of successful collective action (Leana & Van Buren, 1999; Tsai & Ghoshal, 1998). Indeed, formation of trust within the family business, as well as an ability to avoid distrust, are associated with lasting success through generations of the family business (LaShapelle & Barnes, 1998). Gulati (1995) posited that trust is incrementally developed with repeated interactions because the trusting parties learn about each other and build trust around "norms of equity."

Social interaction creates opportunities for information exchange and a series of information exchanges shapes the parties' experiences about how the information has been used. These experiences then influence the perceptions of trustworthiness (Krackhardt, 1992). Social interaction also enables open and prompt communication needed to settle any differences, thus enhancing trust among parties (Das & Teng, 1998). Powell (1996) argued that trust is a learned attribute, and is therefore a result of ongoing interaction. He has also noted that "without mechanisms and institutions that sustain...conversations, trust does not ensue" (1996: 63).

The need for interaction among family members, so as to avoid disruptive conflicts between the family and business, has been a consistent theme in the family business literature (e.g., Neubauer & Lank, 1998). Lansberg argued that trust needed for collaboration requires "regular maintenance," and that communication "is the foundation on which trust is build" (1998: 340). Otherwise, "in wealthy extended dynastic families the basis for trust, cooperation, and moral authority erodes because of the dominance of the self-interest and the loss of ancestor's authority" (Davis & Herrera, 1998: 253). Trusting relationships within the family can be expected to influence trust forming between the family and management due to family's involvement in the family business through multiple roles.

> **Hypothesis 13.** The higher the level of social interaction among the family members, the higher is the trust among the owner family and top management.

Shared Vision and Decision Quality

A shared vision can positively influence decision-making in complex and ill-structured business situations, because it promotes information sharing among stakeholders and encourages specialization and the production of high-quality information for the decision-making process. Strategic decisions are often complex and usually demand the analysis of large amounts of data (Eisenhardt, 1989b). When all constituents share a common vision, opportunism is reduced and the sharing of information increases within the firm (Dyer & Singh, 1998; Eisenhardt, 1999; Ouchi, 1980). This provides for richer information for strategic decisions, improving decision quality. Also, a shared understanding of roles and related tasks promotes internal role specialization (Ring & Van de Ven, 1994), which improves the quality of information that different stakeholders make available for decision processes. The enhanced search heuristics resulting from higher specialization also improves the ability of the family firm to monitor and learn about its environment, further improving the quality of its strategic decisions. Also, when the amount of information to be analyzed is great, information overflow may impede, rather than facilitate, strategic decision making (Brown & Eisenhardt, 1997). A shared vision provides a common framework by which to assess available information and focus on relevant issues.

Family business literature has identified many relational aspects, pertaining to long-term relationships, which support the positive association between the shared vision and decision quality. Ward (1997) found that “disparate” family goals and values hinder family business growth, and he proposed that defining family purpose, mission, and values is the most important “best practice” to ensure long-term family business growth. Also, family values, in addition to the shared vision, can provide guidance in decision making by defining desired and undesired forms of behavior (Adams, Taschian & Shore, 1996; Gallo, 1998). A similar view was presented by McCollom, who argued that “common language and conceptual categories” (1988: 408) help to integrate activities among the family and business. Finally, Aronoff & Ward (1995) noted that “fusion of family goals and business strategy” could be a unique strength of family firms (1995: 122).

> **Hypothesis 14.** The greater the shared vision among the owner family, the better is the strategic decision quality in the family firm.

Shared Vision and Decision Commitment

The relational governance model addresses both the management's and the family members' commitment to strategic decisions. Obviously, the degree of the separation of the family and management depends on the sizes of the family and the company, and the family's propensity to participate in the management. Because of the commitment of both groups is deemed important, they are modeled separately in the model. Also, family members' participation in decision processes may vary from full participation to no participation. The level of individual family member's involvement in decision making depends largely on the number of different roles he or she holds in the family business system, personal motivations, and the degree of autocracy in decision making.

Shared vision and cooperation are closely linked. Successful implementation of strategic decisions requires the cooperation of decision-making teams. The level of cooperation in implementing strategic decisions is determined by the decision-making teams' commitment to the intended outcomes. Decision commitment implies the acceptance of choices and the intention to cooperate with others in their successful implementation. Gaining commitment to strategic decisions is a challenge because strategic decision processes are laden with conflicts. These conflicts create the requisite diversity of information necessary to map and analyze strategic options (Dooley & Fryxell, 1999).

Leana & Van Buren (1999) proposed that a shared vision, reflecting "associability" with the organization, increases willingness and ability of the organization's members to subordinate their individual goals and actions to collective goals and actions. According to Leana & Van Buren, a shared vision provides the members with a rationale to be "good agents," and to commit themselves to collective goals and actions, and defer their individual wants. Thus, family business participants' commitment to strategic choices should be enhanced by the shared vision.

Shared vision promotes coherence in stakeholders' expectations and opinions on organizational goals. Shared agreement on organizational goals also serves to strengthen stakeholders' commitment to achieving these goals. Shared vision also promotes cooperative behavior through clarified role interactions (Ring & Van de Ven, 1994). Established role interactions and related expectations concerning the behaviors, contributions, and obligations of each stakeholder promote cooperative behaviors and commitment to jointly agreed decisions. Established role interactions and shared vision also reduce the threat of opportunistic behavior and help establish a social norm of reciprocity, which reinforces commitment to jointly agreed decisions (Uzzi, 1996). Absence of distrust resulting from goal conflict and open discussions of decisions also improves managers' perceptions of the fairness of the strategic decision process (Korsgaard et al., 1995), leading to greater commitment to the chosen strategy.

A shared vision among the owner family demonstrates other constituencies that the family has a degree of cohesiveness, and they are able to cooperate towards realizing their collective ownership-related goals. Also, the shared vision provides broad guidelines for strategic decision making in the company. Shareholders' clarified expectations and their willingness to cooperate can be expected to commit managers to strategic choices.

> **Hypothesis 15.** The greater the shared vision among the owner family, the stronger is the management's decision commitment in the family firm.

The strategic choices should be well aligned with the shared vision. This is influenced by the family members' multiple roles in the family business, and their ability to closely monitor strategic decisions in the company.

> **Hypothesis 16.** The greater the shared vision among the owner family, the stronger is the family's decision commitment in the family firm.

Trust and decision quality

Extant literature suggests that trust has a positive influence on decision making. For example, Zand has noted that "shared trust or lack of trust apparently are a significant determinant of managerial problem-solving effectiveness" (1972: 229). The arguments are based on improved information processing. As discussed earlier, high-quality decisions require a large amount of information. The amount and quality of information need to match the complexity of the problem (Leifer & Mills, 1996). As strategic decisions are complex and ill structured, the information requirements are especially high. High levels of trust result in "relevant, comprehensive, accurate, and timely information" (Zand, 1972: 231) and it "gives exchange partners the confidence to be open toward each other" (Zaheer et al., 1998: 145). Also, a high level of trust can increase cooperation in decision-making teams by encouraging help-seeking behavior (Jones & George, 1998).

On the contrary, decision making with low trust results in reduced information sharing and to increased politics that impede the flow of information (Dooley & Fryxell, 1999; Eisenhardt & Bourgeois, 1988). A high level of trust may also promote cognitive conflict that is considered to potentially improve decision quality (Zaheer et al., 1998). More specifically, trust may promote desired cognitive conflict and reduce dysfunctional affective conflict (Amason, 1996). This view is supported by Cosier & Harvey who noted that "if mutual trust can be established and maintained, there is an opportunity for more effective collaboration between family business members by encouraging and using constructive conflict to identify win-win outcomes" (1998: 77).

Cohesive decision-making groups may experience concurrence-seeking behavior, or "groupthink," which reduces decision quality due to reduced effort to find new solutions (Janis, 1989). Davis & Herrera (1998) proposed that social demands to reach consensus decisions might make family businesses particularly vulnerable to groupthink. Trust among family business members may reduce conformance pressures, and thus encourage the seeking of a wider range of alternative courses of action, leading ultimately to better quality decisions (Walsh, 1994).

> **Hypothesis 17.** The higher the trust among the owner family and top management, the better is the strategic decision quality in the family firm.

Trust and decision commitment

Trust-related benefits are particularly potential in family firms due to the long-term nature of exchange relationships. This is observed by Litz who succinctly noted that "management researchers have committed the error of overlooking the role of tribal, and more specifically familial, factors that characterize the vast majority of firms," and that "given the demonstrated agency-related problems that frequently plague non-family-held concerns, and the apparent trust-based advantages that appear more readily attainable by family firms, business researchers may be well advised to reconsider the potential significance of family influence within the firm" (1997: 66). Similarly, Davis & Harveston noted that "since family members would likely trust each other more than unrelated individuals, family firms may actually have a competitive advantage" (1998: 35). However, as family business literature has demonstrated, trust cannot be taken for granted in family firms, and distrust can be a very destructive force. Consistent with these overall claims that trust can be a source of competitive advantage in family firms, the following two hypotheses argue that there is a relationship between trust and commitment to strategic decisions.

Trust and cooperation appear closely linked. Although the direction of causality is not obvious (Gambetta, 1988), many scholars have argued that trust can improve cooperation among individuals and groups (e.g., Mayer, Davis & Schoorman, 1995). Gaining wide commitment to high quality decisions can present a challenge because reaching high quality decisions requires certain amount of cognitive conflict to generate the necessary diversity of information (e.g., Dooley & Fryxell, 1999). If higher levels of trust are associated with an honest and open discussion atmosphere, then higher levels of trust are likely to result in discussions that are more related to the facts relevant to the decision making task and less related to interpersonal disputes. As was discussed earlier, trust may induce cognitive conflict and reduce affective conflict. Amason (1996) found in an empirical study that cognitive conflict is positively related and affective conflict is negatively related to decision commitment. Thus, trust should increase decision commitment through positive effects on cognitive conflict and negative effects on affective conflict. Additionally, high levels of discussion related to decisions should increase participants' perceptions of high "procedural justice" in the decision-making process because of increased personal involvement in the process (Korsgaard et al., 1995).

Family business managers' dependence on the owner family members varies greatly. When the owner-manager runs the business, the dependence is generally low. On the other hand, when managers are not major shareholders, the dependence is higher. In those cases, the managers are more vulnerable to behavior and decisions of the owner family. Greater trust between the family and management implies that managers have confidence in the family's cooperation, and they can expect that the family will comply with jointly agreed commitments (Das & Teng, 1998; Cummings & Bromiley, 1996). This confidence in family support is likely to increase managers' commitment to the successful implementation of strategic decisions.

> **Hypothesis 18.** The higher the trust among the owner family and top management, the stronger is the management's decision commitment in the family firm.

Lack of information or incomplete information on the processes and outcomes of decision making implies the presence of risk to owner family members (Leifer & Mills, 1996). Trust among the family and management suggests an acceptance of potential risk in decision making, thus increasing the level of commitment to strategic decisions (Ring & Van De Ven, 1992). Further, past research in procedural justice indicates when group members have fewer opportunities to influence a decision, the more sensitive they become to procedures used to make the decision (Sapienza & Korsgaard, 1996). Thus, when family members have less direct influence on strategic decisions, procedural factors, such as having a chance to use voice (Korsgaard et al., 1995), have stronger effects on the perceived fairness of the decision process. Empirical research has shown that procedural justice is positively related to trust and decision commitment in entrepreneur-investor relations (Sapienza & Korsgaard, 1996). Thus, it can be expected that a high level of trust is associated with a high level of the family's decision commitment.

> **Hypothesis 19.** The higher the trust among the owner family and top management, the stronger will be the family's decision commitment in the family firm.

Mediating relationships in the relational governance model

The direct effects hypotheses in the relational governance model linked family institutions and family size with social interaction, and social interaction with shared vision and trust. Finally, both shared vision and trust were directly linked to all three decision-making quality constructs, including decision quality, management's decision commitment, and family's decision commitment. Additionally, the relational governance model shown in Figure 4.6 suggests several indirect relationships among the variables. While family institutions are associated with increased shared vision and trust, and family size with decreased shared vision and trust, it is the social interaction that enables family institutions and family size to influence shared vision and trust.

Hypothesis 20. Social interaction mediates the effects of the variety of family institutions and family size on shared vision and trust.

While social interaction is proposed to be related to the quality of a family firm's strategic decision making, it is the shared vision and trust that convert social interaction into strategic decision-making quality.

Hypothesis 21. Shared vision and trust mediate the effects of social interaction on strategic decision quality, management's decision commitment, and family's decision commitment.

4.4 Complementarity of contractual and relational governance

The contractual and relational governance models, as developed above, were used to study the effects of governance on decision-making quality in two separate models. It can be expected that most of the family firms employ both contractual and relational modes of governance, as least to some degree. Yet, it is not clear what the relationship of these two different types of governance to the firm outcomes is. Literature has indicated the possibility of both complementary and supplementary relationships between formal and social forms of control (Das & Teng, 1998).

A large part of control-related literature has focused on formal, hierarchical control in organizations. A control system is "effective to the extent that task performance meets or exceeds organizational goals and expectations" (Leifer & Mills, 1996: 114). Thus, effective control implies that organizational goals and performance targets have been established. Control systems may include both measurement of performance and rewarding people based on how well the agreed performance targets have been met (Jensen & Meckling, 1998). Control structure is reflected through the whole organization, from the very top level to the “shop floor” level. The effectiveness of formal controls depends on how accurately either the behavior of individuals or outcomes of those behaviors can be measured (Ghoshal & Moran, 1996). Formal control seems to focus on preventing opportunistic and other non-productive behaviors, and on reducing associated agency costs.

Formal control may not be the optimal form of control, especially when the exchange relationship has a long-term nature. Consequently, socially based control mechanisms have been proposed in the literature, as discussed throughout this dissertation (e.g., Ouchi, 1980; Ring & Van De Ven, 1992). Social controls such as norms of reciprocity, trust, and shared values have been argued to reduce control-related costs, and to increase value-adding activities. For example, many authors have addressed the role of trust in reducing opportunistic behavior, and associated agency costs (e.g., Das & Teng, 1998; Nooteboom et al., 1997; Zaheer & Venkatraman, 1995).

The relational type of governance may be more prevalent in small family firms because they are more likely to lack formal controls, and their social capital can be expected to be at a higher level due to smaller and more closely-knit families (Moores & Mula, 2000). In such cases, social controls may substitute for formal controls. Similarly, Harvey noted that “the key features of the family system that usually have the greatest influence on the operation of the firm are the preexisting, implicit, social ties among family members...[that] are often an effective substitute for the relatively more formalized, explicit contractual relationships” (1999a: 61). This may not be always true, however, because even smaller families do not always exhibit high levels of social capital. Lack of trust, for example, and associated family feuds have destroyed many family businesses (e.g., Kets De Vries, 1996).

Further, formal controls such as board monitoring are not free from social influences (e.g., Westphal, 1999). In family firms, formal and social controls are intertwined in a complex way due to the multiple roles family members may have. Also, relational governance that regulates the relations between the family and business may exhibit some formal aspects. For example, family members may explicitly agree in “family protocols” or in “family constitutions” on the rules for ownership transfers (Montemerlo, 2000). Interestingly, agreements among family members resemble “relational contracts” known in law and economic literature (e.g., Williamson, 1985; Macneil, 1978). Relational contracts are flexible and are stated broadly, serving to set common expectations. Milgrom & Roberts described a relational contract as “an agreement that frames the relationship,” and where “the parties do not agree on detailed plans of action but on goals and objectives, on general provisions that are broadly applicable” 1992: 131).

Although social control may substitute for formal control to some degree, and vice versa, it is argued here that contractual and relational modes of governance are complementary. Social and formal controls partly serve different purposes, and they affect through different mechanisms. Contractual governance, as a task of boards of directors, is targeted to protect the shareholders’ interests, and to ensure the long-term viability of the company. By doing this, contractual governance focuses on the ownership-management axis of family business governance. On the other hand, the relational governance is about processes within the family addressing a variety of issues by which the family is linked to the company. As such, relational governance is a form of voluntary cooperation among a specific shareholder group, the family. The argument of complementarity of formal and social controls is consistent with Corbetta & Montemerlo’s proposition that “family firms should find great interest in...the orientation to separate ownership, governance [i.e. boards of directors], and top management roles” (1999: 373). Also, family business literature argues that both business governance and family governance should be part of effective family business governance (e.g., Lansberg, 1999).

> **Hypothesis 22.** Contractual and relational governance mechanisms have a complementary effect on decision-making quality.

4.5 Strategic decision-making quality and firm performance

The contractual and relational governance models developed in previous sections examined various formal and informal governance mechanisms, and their effects on the strategic decision-making quality of a family firm. In this section, hypotheses on the effects of decision-making quality on the overall performance of a family firm are developed.

Strategy research has not been able to convincingly show how a firm's strategic decision process and the firm performance are related. This is difficult because firm performance is a function of a vast number of different factors that may mask the effects of strategic decision processes (Dean & Sharfman, 1996; Pearce et al., 1987). The strategic choice perspective assumes that managers attempt to optimize their companies' financial performance (Hambrick & Mason, 1984; Judge & Zeithaml, 1992). According to Dean & Sharfman (1996) "managerial choice processes" assume that variations in strategic decision-making processes lead to different strategic choices, which then lead to variations in decision outcomes.

Measuring family firm performance is generally problematic. Although family-owned businesses range from small firms to large multinational enterprises, the majority of family firms are small, privately held entrepreneurial companies (Morris, Williams, Allen & Avila, 1997). Such firms are unwilling to disclose performance information, making it difficult to obtain traditional financial measures of performance (Chandler & Hanks, 1993). Also, research has shown that firm performance is a multidimensional concept (Venkatraman & Ramanujam, 1996). This makes the firm performance evaluation open to interpretation, depending on what definitions and measures of performance are used. Finally, the same performance level may be considered good in one company, while only mediocre in another company, indicating that performance cannot be assesses without regard to contextual factors, such as aspired performance levels in a particular firm or industry-related factors.

The present study examines the performance of family firms using two different, but related, dimensions of the overall firm performance, that is, profitability and growth. Both performance criteria are linked to a firm's long-term viability and survival. Profitability generally refers to how efficiently the firm is using it assets. Different financial ratios, such as return on assets or return on equity, may be used to assess a firm's profitability. Firm growth refers in this study to sales growth. Profitability and growth are related because a firm's growth rate is partly constrained by profitability. Prolonged poor profitability translates into reduced financial resources, thus limiting the amount of investments that can be made to achieve growth.

In the present study, both profitability and growth are subjectively assessed in broad categories. This approach allows problems caused by unwillingness to disclose information to be overcome, while not sacrificing precision of measurement to a significant degree (Chandler & Hanks, 1993). Because performance can be seen as attainment of firm goals, literature on strategy has suggested that firm performance should be analyzed in the light of firm goals (Sanchez & Heene, 1997). Thus, the analysis of performance in this study takes into account the profitability and growth goals. Figure 4.6 illustrates the research model linking decision-making quality to the performance of a family firm.

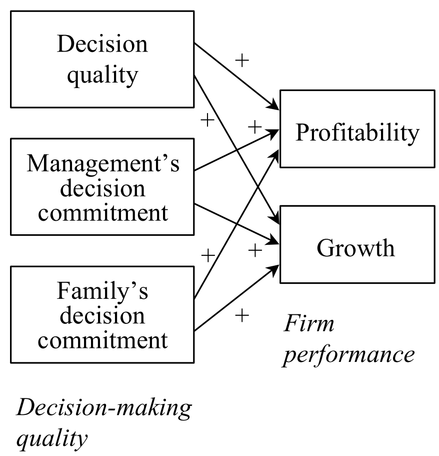

Figure 4.6 Strategic decision-making quality and family firm performance

Earlier strategic planning literature regarded strategy formulation and its implementation as separated, independent phases of the process. More recent strategic decision-making literature claims that the strategy formulation phase, addressing the generation of decision alternatives and their evaluation against some criteria, affects both the quality of decisions, and their effective execution, often in a seemingly paradoxical way (Amason, 1996; Dooley & Fryxell, 1999; Korsgaard et al., 1995; Wooldridge & Floyd, 1990). On the one hand, reaching high quality decisions is benefited by a divergence of opinions within the team, thereby providing more diverse information needed for better decisions. The needed cognitive conflict during the formulation phase may adversely affect team members' consensus on the strategic choices, especially if there is non-productive affective conflict among the team members. On the other hand, team consensus on decisions is deemed crucial for successful execution of the decisions. Thus, soliciting cognitive conflict, avoiding affective conflict, and building consensus all at the same time, seems to be the key to achieve decision quality and decision commitment, as well as improved firm performance.

The contractual and relational governance models identified a number of factors that are hypothesized to have a positive effect on decision quality and decision commitment. In the models, neither decision quality nor commitment is specified in terms of any specific measure of firm performance. This allows the presentation of hypotheses on relationships between the three decision-making quality constructs and two firm performance constructs, under three hypotheses.

As discussed earlier, high strategic decision quality is related to information processing capabilities during the planning phase. Information used in the identification, development, and selection phases needs to match the complexity of the strategic challenge. This complexity may include both uncertainty, i.e. the state of not knowing, and ambiguity about meanings of a variety of information (Leifer & Mills, 1996). Strategic decisions are always complex because they are non-routine, and involve the whole business system. Also, stakes are very high when strategic choices are committed. Bad choices may have severe impacts on the firm's performance, or even on its very survival.

To reach high quality strategic decisions, a large array of issues needs to be considered, such as the internal consistency of the strategy, consistency with the environment, resources available, amount of risk, and time horizon (Tilles, 1963), stakeholder expectations (Freeman, 1984), organizational goals (Bourgeois, 1980), competitive forces in the industry and positioning of the firm (Porter, 1980; 1985), unique firm-specific resources (Penrose, 1959) and environmental dynamism (Eisenhardt, 1989b). Given the number of issues that should be considered during the formulation phase, it is obvious that decision quality is related to rationality of the decision-making process. Although there are mixed results relating to how decision process rationality and firm performance are related (Eisenhardt, 1989b), researchers have found a positive relationship between rationality and firm performance (Priem et al., 1995a).

Hypothesis 23.

Hypothesis 23a. The better the strategic decision quality, the higher is the profitability of the family firm.

Hypothesis 23b. The better the strategic decision quality, the faster is the growth of the family firm.

Ultimately, superior firm performance hinges on the willingness of the whole organization to commit to the strategic choices. It is often argued that consensus on choices contribute to team members' affective responses, such as commitment to decisions, which in turn lead to increased cooperation (Korskaard et al., 1995). As top-level managers are supposed to lead the organization, their motivations and behaviors are vital in mobilizing the rest of the organization. Middle management support is central because it is usually heavily involved in implementing strategy. Wooldridge & Floyd noted that "uncommitted middle managers may give implementation a low priority, engage in 'foot-dragging', create implementation obstacles, or even sabotage strategy" (1990: 232). In a same vein, Amason noted that "commitment is also important because it reduces the likelihood that a particular decision will become the target of cynicism or countereffort" (1996: 125). In sum, commitment to strategic choices induces high levels of voluntary cooperation during the implementation, while uncommitted individuals may effectively obstruct the implementation.

Hypothesis 24.

Hypothesis 24a. The higher the management's decision commitment, the higher is the profitability of the family firm.

Hypothesis 24b. The higher the management's decision commitment, the faster is the growth of the family firm.

Much of the family business literature has questioned the owner family's contribution to family business (Dyer, 1994). More recently, several authors have suggested that the family may be a source of sustained competitive advantage to the family firm (e.g., Davis & Herrera, 1998; Dyer & Handler; 1994). Specifically, it is proposed here that the family's decision commitment has a positive effect on the family firm's performance. This may be so for several reasons. The owner family has the final control over the firm's resources. If the family is not committed to strategic choices, it may not release all the resources needed in the implementation of the selected strategy (Pfeffer & Salancik, 1978). Also, lack of support from the family may reduce management's willingness to take risks, which are inevitably involved in executing strategies. Such risk aversion is likely to result in slowing down resource commitments needed in implementing strategic decisions. Further, the family's low commitment to strategy may decrease outside managers' motivation to stay in the company. The resulting managerial turnover can be expected to affect the implementation of strategies adversely.

Hypothesis 25.

Hypothesis 25a. The higher the family's decision commitment, the higher is the profitability of the family firm.

Hypothesis 25b. The higher the family's decision commitment, the faster is the growth of the family firm.

4.6 Summary of hypotheses

This chapter has developed three separate models with the aim of explaining the governance structures found in family firms, and their effects on performance. The first model addressed contractual governance mechanisms, and their effects on strategic decision-making quality. Similarly, the second model examined relational governance, and their effects on strategic decision-making quality. The third model focused on the relationship between decision-making quality and family firm performance in terms of profitability and growth. Additionally, a hypothesis concerning the complementary nature of the relationship between contractual and relational forms of governance was presented. Figure 4.7 shows the combined research model with the hypothesized relationships among the constructs. The next two chapters of the present dissertation are devoted to the empical testing of the hypotheses. First, the methodology used for empirical testing is described, then the results of the tests are presented.

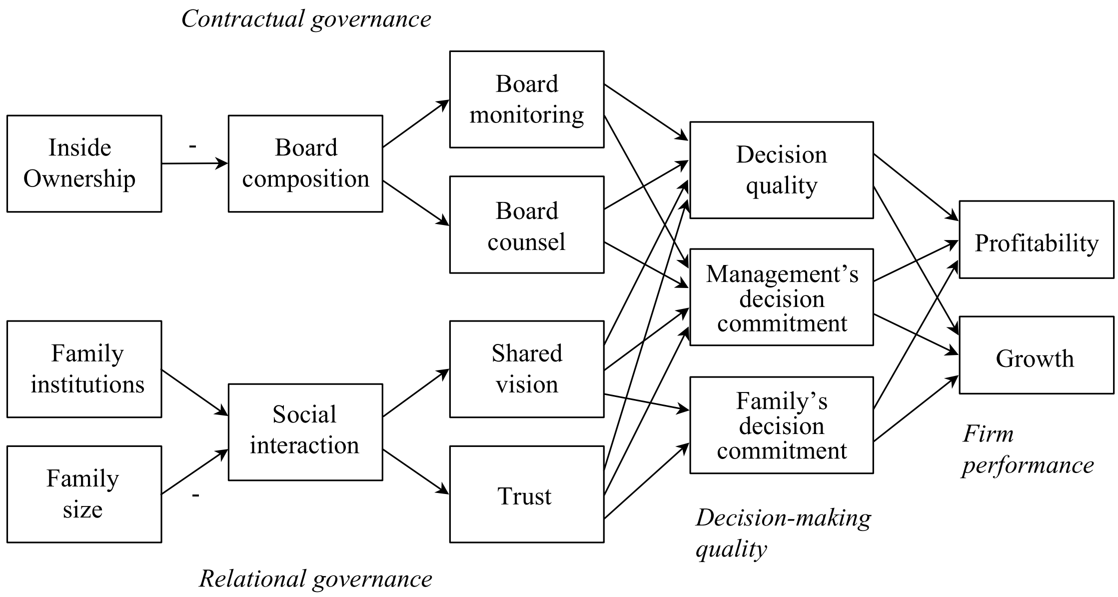

Figure 4.7 Combined research model

5 METHODOLOGY

This chapter describes the methodology for testing the hypotheses presented in the previous chapter. First, the main statistical methods are reviewed. Then, the data collection process is described addressing the sample, questionnaire, and responses to the survey. After that, the operationalization of the model's variables is explained. Finally, the reliability and validity of the empirical analysis are discussed.

5.1 Statistical methods

5.1.1 Confirmatory factor analysis

Factor analysis is an interdependence method used to identify a few factors that are responsible for the correlation among a group of variables. In this study, confirmatory factor analysis (Jöreskog, 1969) is used for analyzing the validity and reliability of theoretical, latent constructs that are measured by multiple indicators in questionnaire.

In factor analysis each variable is expressed as a linear combination of underlying factors. The coefficients in the linear combination are called factor loadings; they determine how much each factor is responsible for the variation in each variable. Variance of each variable is divided into a specific component unique to the variable and a component of variance shared with the factors. The factors are derived so that the first factor accounts for the largest share of the variation, the second factor accounts for the second largest share of the variation, and so on. The eigenvalue represents the variance explained by each factor. The objective of the factor analysis is to identify a set of common factors that are responsible for most of the total variation and that are fewer in number than the variables. Factors can be extracted by various computational methods. In this study, principal components analysis is employed for the factor extraction (Sharma, 1996).

This study adopts the rule that factors having eigenvalues greater than 1.0 will be retained. The reasoning of this rule is that factors with an eigenvalue of less than 1.0 should not be used because it accounts for less than the variation explained by a single variable (Aczel, 1999). A factor solution is not unique because there are an infinite number of solutions that satisfy the conditions of factor extraction. Factor rotation can be used for finding a factor solution that can be interpreted meaningfully. This study employs VARIMAX rotation whenever the factor solution indicates that more than one factor has an eigenvalue greater than 1.0. VARIMAX rotation is used for finding a factor structure where a variable loads highly on one factor only and loads lowly on other factors (Sharma, 1996). This study uses the common rule of thumb suggesting that measurement items with factor loadings of .6 or higher on the primary dimension and .4 or lower on all other dimensions are retained.

In the present study, confirmatory factor analysis is complemented by the use Cronbach's alpha coefficient (Bohrnstedt, 1983). Cronbach's alpha is used to assess internal consistency reliability, that is, consistency of results across measurement items. Calculation of Cronbach's alpha takes into account the number of measurement items and correlations between the items. It is recommended that Cronbach's alpha should be greater than .7 and, at least, it should not be less than .5 (Nunnally, 1978).

5.1.2 Multiple linear regression analysis

Multiple linear regression analysis is a statistical dependence method used for analyzing the relationship between one dependent and several independent variables. It can be used for testing hypotheses or predicting values for dependent variable. The generic form of the multiple linear regression model is

$$y_i = \beta_0 + \beta_1 x_{i1} + \beta_2 x_{i2} + \ldots + \beta_k x_{ik} + \varepsilon_i$$

where y is the dependent variable, $x_1, \ldots, x_k$ are independent variables, $\beta_{0, \ldots,} \beta_k$ are regression coefficients, index i refers ith case in the n sample observations, and ε is an error term, or disturbance term. In the use of linear regression, it is normally assumed that relationships are linear, error terms are normally distributed and have zero means, and that observations are independent.

The unknown parameters $\beta_{0,...,}\beta_k$ are estimated by using a fitting criterion. The most common method of estimating the parameters of the linear regression model is the ordinary least squares method (Greene, 1993), which minimizes the sum of squared residuals. The least squares method for estimating regression coefficients is used in this study when testing hypotheses on relationships among constructs.

Statistical inference is inductive in its nature, i.e. propositions are considered true or false only with a certain probability. The significance level is a pre-selected probability of declaring the null hypothesis false when it is actually true. A significance level of .05 is widely used in testing hypotheses; in social sciences a significance level of .1 is still acceptable (Frees, 1996). In this study, p values below a level of .05 are considered significant, and below a level of .1 marginally significant.

Individual hypotheses are examined by analyzing beta coefficients $\beta_{0,...,}\beta_k$. A hypothesis is supported if the sign of the beta coefficient is as hypothesized and if the p-value of the coefficient is below the pre-selected significance level. A t-test is used to test whether the beta coefficient is significantly different from zero by comparing the critical t-value to the ratio of the estimated beta-coefficient to its standard error. Standardized beta-coefficients can be used for comparing the relative explanatory power of each independent variable. A coefficient of determination R^2 represents the proportion of variation in the dependent variable that can be accounted for by the variation in the independent variables. Mathematically, $R^2 = 1$ - (error sum of squares)/(total error sum of squares). The use of the ordinary least squares method automatically maximizes R^2, because it minimizes the sum of squared errors. Adding new independent variables to the regression model may artificially increase the value of R^2. To avoid this problem, an adjusted R^2 is often used as an indicator of the explanatory power of the model. Adjusted R^2 takes into account the number of independent variables and sample size. F statistics is used to evaluate the significance of the joint effect of all independent variables.

A multicollinearity problem arises when two or more independent variables are linearly related, or approximately so. When independent variables are highly related, information on how independent variables contribute to the variation in the dependent variable is reduced and the estimation of regression coefficients deteriorates. Multicollinearity between two variables can be detected by checking their correlation coefficient. It has been suggested that the value of a correlation coefficient greater than .8 indicates severe multicollinearity (Judge, Hill, Griffiths, Lütkephol & Lee, 1988; Kennedy, 1992). Multicollinearity can also be detected by analyzing variance inflation factors VIF, which indicate the degree an independent variable can be expressed as a linear combination of other independent variables. VIF value 1.0 means that the variable is orthogonal to all other independent variables, thus implying no multicollinearity. A VIF value greater than 10 indicates problematically high multicollinearity (Kennedy, 1992).

The explanatory power of multiple regression analysis is directly affected by sample size. Hair, Anderson, Tatham & Black (1995) have given guidelines for the minimum and maximum sample size. The minimum sample size is 20-30 observations, whereas large samples with more than 1000 observations can result in overly sensitive regression analysis. Additionally, Hair et al. (1995) have suggested a minimum of 15 to 20 observations per independent variable.

The family firm governance model presented in the previous section implies several indirect relationships, in addition to direct effects between variables. More specifically, the type of indirect effect examined in this study is mediation. Figure 5.1 illustrates the basic sequence of variables in mediation, in which the effect of A on C takes place through B.

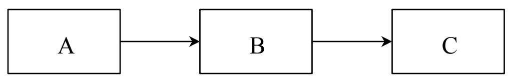

Figure 5.1 Mediating relationship between A and C through B

Variable B functions as a mediator when the following three conditions are fulfilled (e.g., Baron & Kenny, 1986). First, variations in the independent variable A significantly account for variations in the assumed mediator B. Second, variations in the independent variable A significantly account for variations in the dependent variable C. Third, when variables A and B are entered simultaneously, the previously significant relation between A and C is no longer significant, while B has a significant effect on C. Mediation is partial when the relation between A and C is still significant in the third stage, but at reduced level compared to the second stage.

5.2 Data collection

5.2.1 Population and sample

The target population of the study consists of family businesses in Finland. No specific limitation was placed on the type of business. Generally, finding samples for family business research is challenging because there is lack national statistics on family business (Chua, Chrisman & Sharma, 1999; Johannisson & Huse) This is also the case in Finland. Empirical research on family business has relied a lot on samples based on membership lists of professional associations or mailing lists of family business consultants (Chua, et al., 1999).

The sample of the present study is partly drawn from the membership directory of the Family Business Network Finland. This prominent and respected association is well connected to Finnish firms that identify themselves as family firms. Also, the new member recruitment list of Family Business Network Finland was used to form the sample. The list had been composed regionally by representatives of member companies and their contacts in local institutions such as chambers of commerce. These sources produced as comprehensive a list as possible of potential family businesses in Finland.

The sampling of firms was based on three criteria, supporting the investigation of the research problem of the present study. First, firms in the sample had to be corporations, not any other form of organization. This allowed the testing of the hypotheses about boards of directors. Second, the firm had to be controlled by one nuclear or extended family. If several different families controlled a firm, then the influence of social capital embedded in a given family on strategic decision-making might be clouded. Third, the firm had to be at least five years old, in order to ensure it had already developed governance structures.

The initial list of potential family businesses included 545 firms. During the first round of evaluation, 128 companies were excluded from the sample because they failed to fulfill the first sampling criterion: they were not corporations. This evaluation was based on multiple sources, including the list of firm names, trade registry, and directly contacting the companies. The initial screening of companies produced a base sample of 417 family firms.

5.2.2 Questionnaire

Development of the questionnaire was guided by the theory presented in the previous section, extant literature on operationalizations of the constructs used in the hypotheses, and exploratory interviews with five family firm executives, three coming from a family business with concentrated ownership (three owners) and two coming from a family business with spread-out ownership (large extended family and non-family owners). An eight-page questionnaire had six main sections: (1) description of the business, (2) ownership structure, board of directors, and family's participation in the business, (3) strategic decision making, (4) administration of the company, (5) relationships within the family, and among the family and company, and (6) size of the business and evaluation of financial results. The questionnaire consisted of 97 statement-style scaled items and 49 various other types of questions, 146 questions altogether. The questionnaire is shown in Appendix A.

After constructing the survey instrument, it was pre-tested with the help of seven family business executives. The test respondents' were asked to read the accompanying cover letter and fill the questionnaire according to instructions. Then they were asked to check whether

- the cover letter motivates the key informant to respond to the questionnaire
- the answering instructions are clear
- the question items can be understood and are unambiguous
- the question items can be answered without too much effort
- the question items feel intrusive

The feedback from test interviews was then used to modify the questionnaire to increase the chances of a high response rate and of obtaining higher quality answers. Time to fill the questionnaire was around 30 minutes. The test respondents were excluded from the final mailing list.

5.2.3 Response pattern

It was important to have respondents who had a good understanding of both the business and the family. Therefore, whenever possible, the questionnaire was primarily targeted at family members who were either the chairman of the board or chief executive officer. All 417 companies of the base sample were contacted by phone prior to sending the questionnaire. The purpose of the calls was to identify the respondents' name, position, and contact information. The information was obtained from the switchboard operator or from a secretary.

The survey questionnaire was send to 417 companies at the end of April 2000. The average response time was 27 days, while the minimum was 2 days and maximum 140. The response time was skewed towards a short response time as indicated by a median of 14 days. After about two weeks from mailing the questionnaires, a process of making follow-up calls to non-responding firms was started. Altogether, follow-up calls were made to 280 firms, up to three calls per one firm. The questionnaire was re-sent to 63 firms.

Table 5.1 shows the response pattern of the study. The final sample size was 402 firms, after 15 cases were excluded. 198 questionnaires were returned; the number of usable responses was 192. The effective response rate was thus 48%, which compares favorably with similar studies (Fiegener et al., 2000; Gabrielsson & Winlund, 2000). On average, responding firms were 57 years old, generated € 58 million annual sales, and had 7.3 owner family members. Respondents held senior leadership positions in their firms: 57% were CEOs, 34% were board chairs, and 9% were other managers and board members. In all cases but one, the respondent was a member of the owner family. Respondents were dominated by males: 16 (8.3%) respondents were female.

Table 5.1 The response pattern of the study

		Number of firms	Percentage
Number of firms the questionnaire was sent to		417	
Firms excluded from the sample after follow-up calls:		(15)	
- Family had sold the firm	4		
- Firm owned by two or more separate families	3		
- Respondent did not consider the firm as a family business	6		
- Firm was part of a company already in the sample	1		
- Firm was not a corporation	1		
Sample size		**402**	**100.0%**
Firms that did not return the questionnaire:		204	50.7%
- Respondent did not have time to respond	39		
- Respondent did not want to respond	40		
- No specific reason was detected for not responding	125		
Returned questionnaires		198	49.3%
Questionnaires non-usable because of an excessive amount of missing data		(6)	
Number of usable responses		**192**	**47.8%**

5.2.4 Non-response analysis

Mailed surveys have a possibility of response bias caused by low response rates (Fox, Robinson & Boardley, 1998). Even when the response rate is reasonable high in this study, response bias can still be problem. Response bias can be evaluated by comparing early and late respondents. It has been suggested that late respondents are similar to non-respondents, especially after repeated follow-up (Churchill, 1991). Response bias was evaluated by comparing the composition of early and late respondents, as shown in Table 5.2. No significant differences were found between early and late respondents in terms of sales, firm age, family size, or board size. These results suggest that response bias presents no problem in this study.

Table 5.2 Independent samples t-test of the difference between early (first 60) and late (last 60) respondents in terms of sales, firm age, owner family size, and number of members in the board

	Early respondents Mean (s.d.)	Late respondents Mean (s.d.)	t	df	Sig. (2-tailed)
Sales 1997 (€ millions)	38.89 (53.65)	35.33 (73.45)	.29	110	.77
Firm age, years	56.23 (31.05)	51.48 (35.28)	.78	118	.44
Family size	6.15 (6.36)	5.31 (6.01)	.74	117	.46
Board size	4.30 (1.79)	3.85 (1.51)	1.50	117	.14

5.3 Construct operationalizations

This section discusses descriptive statistics and operationalizations of the constructs in the governance model. Confirmatory factor analysis was performed for every construct having more than one measurement item in order to achieve sufficient construct validity. Further, Cronbach alpha coefficients were calculated to check inter-item reliabilities of composite indices. Previously used operationalizations were used whenever possible. If an operationalization was not available from the past empirical research, a new one was developed based on the extant theoretical literature. All statement-style items followed a Likert-scale response format ranging from 1 “do not agree” to 7 “completely agree”. When a measurement item did not follow this format, its scale was explained separately. The construct operationalizations are described in five sub-sections, addressing:

- three dependent decision-making quality variables
- four contractual governance variables
- five relational governance variables
- eight control variables for contractual and relational models
- two dependent and two control variables for firm performance

5.3.1 Decision-making quality variables

Decision-making quality variables consist of decision quality, management's decision commitment, and family's decision commitment. Confirmatory factor analysis was able to find a factor structure where measurement items loaded on their theoretically derived factors, i.e. constructs, as shown in Table 5.3. The table also shows the sources from which the items were adopted. The items were either adopted as such from previous studies or modified to fit the family business research context of the present study.

Table 5.3 Measurement items and factor loadings for decision-making quality variables

Measurement items	Factor 1	Factor 2	Factor 3
Decision quality			
Strategic decisions helped (help) the company achieve its objectives (Dooley & Fryxell, 1999)	**.78**	.25	.15
Strategic decisions are consistent with the family firm's vision (Dooley & Fryxell, 1999)	**.62**	.36	.20
Strategic decisions contribute to the overall effectiveness of the company (Dooley & Fryxell, 1999)	**.88**	.08	.09
Management's decision commitment			
Top management is willing to put in a great deal of effort to see the strategic decisions be successful (Dooley & Fryxell, 1999; Mowday, Steers & Porter, 1979)	.19	**.79**	.06
The decisions were consistent with top management's priorities and interests (Amason, 1996; Wooldridge & Floyd, 1990)	.19	**.77**	.22
Top management have supported strategic decisions that were made (Sapienza & Korskaard, 1996)	.19	**.86**	.18
Family's decision commitment			
Family members support the strategic decisions (Sapienza & Korskaard, 1996)	.24	.24	**.68**
Family members are willing to talk strategic decisions up with other family members as being good for the company (Dooley & Fryxell, 1999; Mowday et al., 1979)	.01	.04	**.90**
Family members really care about seeing strategic decisions be successful (Dooley & Fryxell 1999; Mowday et al., 1979)	.18	.18	**.75**

Principal components analysis and VARIMAX rotation were employed for finding the optimal factor structure. Items loading more than .6 on a primary factor, and less than .4 on any other factor were retained.

Decision quality. Decision quality was measured by three items reflecting the extent to which the strategic decisions made in the recent past helped in achieving the company's objectives, were consistent with the firm's vision, and contributed towards the overall effectiveness. The Cronbach alpha for the construct was .74.

Decision commitment. Both management's and family's decision commitment are based on the same concept of decision commitment. Operationalization of decision commitment variables relies a lot on Mowday et al.'s (1979) work on validation of organizational commitment measures. Both decision commitment variables were measured by three items, as shown in Table 5.4. The Cronbach alpha for management's decision commitment was .79 and for family's decision commitment .73.

Table 5.4 shows the descriptive statistics of the decision-making quality variables. The means of the variables are above the midpoint of the scale indicating a decision-making quality perceived as high. Family's decision commitment has the highest spread of the values.

Table 5.4 Descriptive statistics of the decision-making quality variables

	N	Min	Max	Mean	Median	Standard deviation
Decision quality	191	4.00	7.00	5.87	6.00	.73
Management's decision commitment	191	3.67	7.00	6.02	6.00	.76
Family's decision commitment	192	1.67	7.00	5.48	5.67	1.10

5.3.2 Contractual governance variables

Inside ownership. According to the agency theory, ownership structure is the main variable determining how decision-making processes are structured within a firm (Fama & Jensen, 1983). Agency theory divides equity into two parts: inside equity owned by managers and outside equity held by any one outside of firm (Jensen & Meckling, 1976). It is the proportion of outside equity that reflects the degree of separation of ownership from management control. Operationalization of inside ownership is based on this distinction between inside and outside equity. Inside ownership was measured by the proportion of the equity owned by “inside” family members, i.e. family members who served on the board or the top management team. Similar operationalization of ownership structure has been used by Kesner (1987) and Luoma & Goodstein (1999).

Board composition. Dalton, Johnson & Ellstrand (1999) have suggested that there are different ways to measure board composition. Board composition was measured in the present study by the ratio of outside members divided by total board size (Daily & Dalton, 1993; Johnson et al., 1993; Johnson & Greening, 1999). Outside members included individuals who were not part of the owner family or the firm’s top management team.

Board monitoring and board counsel are both based on five statements, as indicated in Table 5.5. Factor analysis confirmed two distinctive constructs. *Board monitoring* items address the company’s strategic decision making as well as monitoring of financial performance. The Cronbach alpha coefficient for board monitoring was .87. *Board counsel* reflects the board’s advice role to management, often on an informal basis. The Cronbach alpha for board counsel was .82.

Table 5.5 Measurement items and factor loadings for board monitoring and board counsel constructs

Measurement items	Factor 1	Factor 2
Board monitoring		
Formal financial reports prepared by top management are reviewed in board meetings (Hitt et al., 1996)	.27	**.75**
Return criteria such as return on assets, return on invested capital, and so forth are regularly followed-up in board meetings (Hitt et al., 1996)	.20	**.83**
Cash flows are regularly followed-up in board meetings (Hitt et al., 1996)	.08	**.85**
Return on investment of large individual investments are regularly monitored by the board	.15	**.79**
The board closely monitors top management's strategic decision making (Westphal, 1999)	.37	**.69**
Board counsel		
The board is actively involved in shaping the firm's strategy (Pearce & Zahra, 1991; Zahra & Pearce, 1989)	**.77**	.32
The board and top management often discuss the firm's future strategic choices (Pearce & Zahra, 1991; Zahra & Pearce, 1989)	**.76**	.33
Board members give top management plenty of counsel on the firm's strategy (Pearce & Zahra, 1991; Zahra & Pearce, 1989)	**.85**	.13
Top management very often solicit board assistance in the formulation of corporate strategy (Westphal 1999)	**.69**	.23
Directors provide advice and counsel in discussions outside of board meetings (Westphal 1999)	**.63**	.04

Principal components analysis and VARIMAX rotation were employed for finding the optimal factor structure. Items loading more than .6 on a primary factor, and less than .4 on any other factor were retained.

Inside ownership and board composition have relatively skewed distributions, as indicated in Table 5.6 for descriptive statistics. This can be expected because family firms commonly have active owners' participation in the business. Both board functions have a full range of values from 1 to 7, while the mean values are above the midpoint of the scale.

Table 5.6 Descriptive statistics of the contractual governance variables

	N	Min	Max	Mean	Median	Standard deviation
Inside ownership	189	.00	1.00	.79	.91	.27
Board composition	187	.00	1.00	.21	.00	.25
Board monitoring	192	1.00	7.00	4.95	5.20	1.44
Board counsel	192	1.00	7.00	4.56	4.80	1.25

5.3.3 Relational governance variables

Relational governance variables reflect the social capital among the family and management. The focus of operationalizations is on social capital within the family, because the relational model mainly addresses governance of the family. Social capital within the management is explicitly addressed in the trust construct and implicitly in other constructs, except family size.

Family institutions. Although the extant literature has recognized a need to govern the family, in addition to business, no prior operationalizations existed for family governance. Neubauer & Lank (1998) has used the term “family institutions” for describing various systems and processes used within a family aiming to improve the family’s link to the company. This study relied on descriptive literature on family business governance for finding a set of family institutions (Gersick et al., 1997; Lansberg, 1999; Neubauer & Lank, 1998; Ward, 1997). Four such institutions were identified: informal and formal family meetings, family councils, and family plans. Respondents were asked to indicate whether they used each of these systems. Response categories were ‘yes’ (coded 1) and ‘no’ (coded 0). To develop a measure of family institutions, the four responses were summed. This index has a scale from 0 to 4 indicating the variety of different family institutions in use.

Family size. Family size is operationalized simply as the number of share-owning family members. The actual family size is often bigger than the number of owning family members. For example, spouses, children, and in-laws may be closely involved in the family business without any direct ownership stake. However, membership in a family is ambiguous. Therefore, ownership was used to determine the family size.

Three distinct social capital constructs were confirmed in factor analysis; factor loadings and measurement items are shown in Table 5.7. S*hared vision* was measured with three items reflecting the family's long-term goals on their business. The Cronbach alpha coefficient for shared vision was .77. *Trust* was measured with five statements indicating the level of trust between the owning family and company management. The Cronbach alpha coefficient for trust was .80. *Social interaction* indicates the level of level personal and social ties between the owner family members. The construct was measured with three items, having the Cronbach alpha .69

Table 5.7 Measurement items and factor loadings for shared vision, trust, and social interaction constructs

Measurement items	Factor 1	Factor 2	Factor 3
Shared vision			
Family members share the same vision about their firm (Tsai & Ghoshal, 1998)	.30	**.85**	.10
Family members are committed to the jointly agreed goals of the firm	.16	**.67**	.31
Family members agree about the long-term development objectives of the firm	.21	**.83**	.16
Trust			
Owners can rely on top managers without any fear that they will take advantage of them even if opportunity arises (Tsai & Ghoshal, 1998)	**.66**	.34	.07
Top management takes advantage of family's problems (Cummings & Bromiley, 1996), reverse coded	**.83**	-.01	-.02
Owner family tries to get the upper hand over top management (Cummings & Bromiley, 1996), reverse coded	**.70**	.13	.04
Top management tries to get out of its commitments (Cummings & Bromiley, 1996), reverse coded	**.78**	-.02	.19
Top management regards the owner family as reliable (Cummings & Bromiley, 1996)	**.64**	.32	.27
Social interaction			
Family members maintain close social relations (Tsai & Ghoshal, 1998)	.08	.37	**.76**
Family members know each other on a personal level (Yli-Renko, 1999)	.20	.31	**.65**
Family members seldom visit each other, reverse coded	.06	-.01	**.83**

Principal components analysis and VARIMAX rotation were employed for finding the optimal factor structure. Items loading more than .6 on a primary factor, and less than .4 on any other factor were retained.

Descriptive statistics of the relational governance variables in Table 5.8 show that family size varies from 1 to 118, having, on average, 7.30 share-owning family members. On average, 1.27 different family institutions were in use. Social interaction, shared vision, and trust all have a mean value above the midpoint of the scale. Similarly, Table 5.4 indicated that decision-making quality variables have mean values close to or above six on the seven-point scales. This suggests that these measures may not fully tap the variation in the sample, which could reduce the model fit of the regression analyses.

Table 5.8 Descriptive statistics of the relational governance variables

	N	Min	Max	Mean	Median	Standard deviation
Family institutions	191	0	4	1.27	1.00	1.01
Family size	191	1	118	7.30	4.00	12.12
Social interaction	187	2.67	7.00	5.84	6.00	1.10
Shared vision	189	2.67	7.00	5.45	5.67	1.01
Trust	189	3.40	7.00	6.14	6.25	.83

5.3.4 Control variables in contractual and relational governance models

Multiple control variables were used to capture family, company and industry effects on the relationships depicted in the study's model: (a) control variables for family effects were the generation in charge, dual leadership, voting control, family on the board, and inside ownership, (b) control variables for firm-level effects included size and past performance, and (c) the control for industry effects was environmental turbulence. Table 5.9 indicates how the control variables were used among the contractual and relational governance models.

Table 5.9 Control variables in contractual and relational governance models

Control variable	Contractual model	Relational model
Generation	X	X
Firm size	X	X
Past performance	X	X
Dual leadership	X	X
Voting control	X	
Family members on board		X
Inside ownership[a]		X
Environmental turbulence	X	X

[a] Inside ownership is also an independent variable in contractual governance model.

Generation. Generation in charge indicates which generation of the family is primarily in charge of the family business. The respondent was asked to indicate this by checking an appropriate box in the questionnaire. Generation in charge is likely to affect leadership and decision-making styles (e.g., Lansberg, 1999). Therefore, it was used as a control variable. Generation in charge is similar to company age, which is often used to control for company effects in empirical research. Company age and the generation in charge were highly correlated ($r=.79$ and $p<.001$). Because of a possible multicollinearity problem, the company age was not used as a control variable.

Dual leadership. Dual leadership in a company occurs when the same person holds both the chairman and chief executive officer positions. This is common in family companies, especially when they are younger and controlled by one or few owner-managers. Duality of leadership could increase the chief executive officer's power and entrenchment, but also, it might enhance "a unity of command" in the firm (Finkelstein & D'Aveni, 1994). Therefore, dual leadership was included as a dummy control variable.

Voting control. The owner family's total voting control is used as a control variable in testing hypotheses on contractual governance. A blockholder's, such as a family, voting power is an important governance variable indicating the relative power of different shareholder groups (e.g., Milgrom & Roberts, 1992). Voting control is operationalized as the owner family's votes divided by all votes.

Family on the board. The number of family members on the board could affect the governance of a family business. The family members' presence on the board may enhance the level of social interaction and shared vision among some family members. Therefore, the family's representation on the board was included as a control variable.

Inside ownership. Just as the number of family members on the board can affect social capital among the family and management, so can the family's inside ownership. The family's inside ownership implies, by definition, that the family is actively involved in company management. This means that family members have increased opportunities for social interaction through work, in addition to family life. Thus, inside ownership was entered as a control variable in the relational governance model.

Firm size. Firm size can influence managerial decision processes (Simons, Pelled & Smith, 1999). Managers and directors are less constrained by complex structures and processes in smaller companies (Dalton et al., 1999), which would influence the strategic decision process. Some researchers have also found that company size is an important correlate of board functions (Dalton, Daily, Ellstrand & Johnson, 1998). Therefore, company size is included as a control variable, using the natural logarithm of the company's sales in 1997 (Daily, Johnson, Ellstrand & Dalton, 1998; Johnson & Greening, 1999). A logarithm is used because sales figures are highly skewed towards small sales volumes.

Past firm performance. Past performance of firms affects the vigilance of the oversight on management (e.g., Finkelstein & D'Aveni, 1994). Respondents' assessment of their company's average profitability during the last three years, measured as net profit divided by sales, was used as a proxy for the firm's past performance.

Environmental turbulence. Turbulence may place pressure on senior managers' decision-making processes (Eisenhardt, 1989b). Environmental turbulence was measured with two items. The measurement items and their factor loading are shown in Table 5.10. The Cronbach alpha coefficient for environmental turbulence is .64. This control was used in testing relationships involving decision-making quality or board functions (monitoring and counsel).

Table 5.10 Measurement items and their factor loadings for environmental turbulence construct

Measurement items	Factor 1
Your firm often needs to change its marketing practices to keep up with competitors (Miller et al., 1998)	**.88**
Your firm must frequently change its operating procedures to keep up with competitors (Miller et al., 1998)	**.86**

Table 5.11 shows the descriptive statistics for the control variables.

Table 5.11 Descriptive statistics of the control variables used in contractual and relational governance models

	N	Min	Max	Mean	Median	Standard deviation
Generation	192	1.00	5.00	2.18	2.00	.99
Firm size[a]	181	.15	2001.44	58.51	14.30	175.47
Past performance	190	1.00	5.00	2.17	2.00	1.08
Dual leadership	190	.00	1.00	.21	.00	.41
Voting control	192	.30	1.00	.94	1.00	.14
Family members on board	191	.00	10.00	2.86	3.00	1.38
Inside ownership	189	.00	1.00	.79	.91	.27
Environmental turbulence	191	1.00	7.00	4.15	4.00	1.41

[a] Sales in 1997, million € in 1997.

5.3.5 Firm performance variables

The two variables indicating a family firm's overall performance are profitability and growth. Operationalizations of firm performance were based on the key informants' subjective self-assessment, because no actual profitability or growth data were available through secondary sources. Table 5.12 shows the descriptive statistics for firm performance variables.

Profitability. The profitability index was based on two measurement items. The first item asked how well the objectives concerning the return on equity has been achieved. The scale for the item was from 1 to 7 with the following anchors: 1 = "lagging badly behind the goals," 4 = "goals have been met reasonable well," and 7 = "goals have been met completely." The second item asked to evaluate the firm's return on equity relative to other companies in the same industry on a scale from 5 to 1, by ranking their business in top 20%, next 20%, mid 20%, lower 20%, or lowest 20%. Because the two items used different measurement scales, standardized values (z-scores) were used in the analyses. Factor loadings for both items were .92. The Cronbach alpha coefficient was .82 for the profitability index.

Growth. The growth index was formed in a way similar to the profitability index by using two measurement items, one measuring how well the growth goals have been met and the other measuring the relative growth of the firm compared to other companies in the same industry. The two growth items were measured on the same scales as the two profitability items; one scale was from 1 to 7 and the other scale from 5 to 1. Factor loadings for both standardized items were .89. The Cronbach alpha coefficient was .72 for the growth index.

Profit and growth orientation. A company's orientation towards profit and growth generation was used as control variables in regression equations for testing the hypotheses on the decision-making quality's effect on firm performance. The respondents were asked to assess the importance of various objectives, including profitability and company growth, in two different ways. First, they were asked to rate eleven different objectives according to their importance on a scale from 1 (not important at all) to 7 (the most important). Second, the respondents were asked to allocate a total of 100 points to four different objectives according to their relative importance, so that the most important objective would receive the most points, the next most important objective would receive the second most points, and so on. Because the scales were different, the analyses were completed with standardized values. The factor loading for the two profit orientation items were .83 and the Cronbach alpha was .55. For growth orientation items, factor loadings were .87 and the Cronbach alpha was 67. The Cronbach alphas are at relatively low levels, but still acceptable.

Table 5.12 Descriptive statistics of the firm performance variables and related control variables

	N	Min	Max	Mean	Median	Standard deviation
Profitability	192	-2.56	1.34	.00	.20	.93
Growth	192	-2.43	1.54	.00	.04	.89
Profit orientation	192	-2.87	2.26	.00	-.08	.83
Growth orientation	192	-1.71	3.49	.00	-.09	.87

Standardized values of the measurement items are used in the analyses.

5.4 Reliability and validity analysis

There are two primary criteria upon which any theory may be evaluated: its falsifiability and its usefulness in explaining and predicting phenomena (Bacharach, 1989). Falsifiability of a theory allows its empirical refutation. According to one view, hypotheses cannot be claimed true, they can only be supported, or "corroborated," by subjecting them to various tests (Popper, 1959). Validity is concerned with the quality of the theoretical propositions and hypotheses, as related to their empirical testing. Validity can be addressed on several levels of analysis, each contributing to important aspects of the validity. In this study, validity is assessed on three main levels: validity of measurement, validity of hypothesized relationships, also referred to as "internal validity," and generalizability of the results, also referred to as "external validity" (e.g., Dooley, 1995). Reliability is concerned with errors in data collection. Good reliability of an empirical test is a prerequisite for good validity. Thus, reliability of the study is discussed before addressing the validity issues.

5.4.1 Reliability

Reliability refers to the degree to which results are consistent across repeated measurements (Carmines & Zeller, 1979). Measurement is defined here as "the assignment of numbers to observed phenomena according to certain rules" (Bohrnstedt, 1983: 70). The observed value of the variable of interest is thought to consist of its unobserved true value and measurement errors. Reliability is related to random measurement errors. In repeated measurements, the random errors are assumed to cancel each other out. Operationally, reliability is expressed as the ratio of true score (nonrandom) variance to observed variance (e.g., Bohrnstedt, 1983). The use of repeated measurements in survey research is rarely feasible for the purpose of estimating reliability. In survey research, reliability can be assessed quantitatively and qualitatively by means other than repeating the same test (Babbie, 1990).

The main method of improving and assessing the reliability of data in survey research is to use multiple items to measure a construct within a single test (e.g., Dooley, 1995). The Cronbach alpha is a commonly used reliability coefficient used to estimate the reliability, or internal consistency, of multi-item constructs. The value of Cronbach alpha is determined by the number of measurement items used in defining the constructs and the average correlations of each item with every other. Cronbach alpha greater than .7 indicates good internal consistency reliability for a multi-item construct (Nunnally, 1978). Dooley (1995) has suggested that measures with reliability less than .5 should be avoided, while measures with modest reliability, from .5 to .7, may be used. Low reliabilities contribute to underestimating relationships between the constructs, an effect called "attenuation" (Nunnally, 1978).

The majority of the study's constructs were operationalized using multiple items. Table 5.13 summarizes inter-item reliabilities of the study's 13 constructs having more than one measurement item. Internal consistency of multi-item constructs is generally very good. One social capital variable and three control variables had a modest (more than .5 but less than .7) internal consistency: social interaction (.69), environmental turbulence (.69), profit orientation (.55), and growth orientation (.67).

Table 5.13 Summary of Cronbach alpha reliability coefficients and number of measurement items for multi-item constructs

Construct	Cronbach alpha	Number of measurement items	N
Decision quality	.74	3	191
Management's decision commitment	.79	3	191
Family's decision commitment	.73	3	192
Board monitoring	.87	5	192
Board counsel	.82	5	192
Social interaction	.69	3	187
Shared vision	.77	3	189
Trust	.80	5	189
Environmental turbulence	.69	2	191
Profitability	.82	2	192
Growth	.72	2	192
Profit orientation	.55	2	192
Growth orientation	.67	2	192

In addition to inter-item reliability, the reliability of empirical data sources is of concern. The design of the questionnaire went through several revisions and a pilot test to make the answering as easy as possible, thereby contributing to the reliability of the empirical data. Whenever possible, construct operationalization was based on an objective measure, leaving only a small amount of room for subjective assessment. However, this was only partially possible because many constructs in the models are inherently perceptual, thus exposing them to personal opinion. The yield of data in the questionnaire was good, as indicated by the small amount of missing data. For all the 24 independent, dependent, and control variables, the amount of missing data was 0.93%.

This study relied on a single key informant per firm for obtaining self-reported data. One reason for this is that the respondent needed to have a good understanding of both family-related and business-related issues (Kumar, Stern & Anderson, 1993). Usually, very few persons in a company have insight into both areas. As discussed earlier, in most cases, the respondent was a family member who held the chair or the chief executive officer position, or both. Another reason for using self-reported data is the shortage of objective sources of data on family businesses.

Using self-reported data from a single respondent raises the possibility of common method variance, i.e. significant relationships are caused by methodological bias instead of true association between variables (Spector, 1987). To further check the reliability of the survey data, 144 telephone interviews were conducted with 72 randomly selected respondent firms, consisting of two interviews in each company. All follow-up interviews were conducted with respondents other than the original respondent. Interviewees were selected so that one individual was a non-family top management team member while the other was a family member actively involved in the business. The interviews covered the study's eight key constructs, which are shown in table 5.15. The constructs in interviews included all three dependent decision-making variables, two contractual governance variables addressing the board functions, and three social capital variables used in the relational governance model. All the variables had multiple measurement items in the original survey instrument and the same response format from 1 to 7. The original multiple measurement items in the survey questionnaire could not be used in the phone interviews. If the original items were used, then the interview would have beccme prohibitively time consuming. Instead, one-item summary operationalizations per construct were used as proxies for the original measures. The phone interviews lasted from 10 to 15 minutes each. The phone interviews were conducted between November 2000 and February 2001. The average time lag between the original survey and phone interviews was approximately 6 months.

Correlations for all the eight constructs between the two phone interviews were significant, as shown in Table 5.14. Board monitoring and board counsel had the highest number of significant correlations: all three possible correlations were significant for both constructs. Social interaction had two significant correlations: one between the phone interviews and the other between the original survey-based score and interview with a family member. There were several non-significant correlations between the original survey-based score and interview scores. These non-significant correlations can partly be explained by the long time difference between the survey and the phone interviews, and the different operationalization of the constructs. Using one-item proxies in interviews in place of multi-item operationalizations used in the survey was likely to cause additional errors in the data. Also, there was a considerable time difference between the mailed survey and phone interviews, on the average about six months. This may have caused further errors in data. On the other hand, the two phone interviews per company were methodologically identical and occurred within a few days of each other, and provided consistent results for the measures. In sum, these results give some confidence that common method variance did not cause the significant relationships reported in the study. To further reduce the possibility of common method variance, previously validated measurement items were used whenever possible

Table 5.14 Correlations among two phone interviews and original survey score

	Phone interview 1[a] and phone interview 2[b]	Original survey score and phone interview 1	Original survey score and phone interview 2
Decision quality	.33**	-.10	.21
Management's decision commitment	.33**	-.09	.12
Family'decision commitment	.24*	-.02	.14
Board monitoring	.53**	.26*	.25*
Board counsel	.36**	.37**	.28*
Shared vision	.39**	.08	.12
Social interaction	.27*	.12	.44**
Trust	.26*	-.10	.14

** $p < .01$; * $p < .05$; two-tailed test; N = 72
[a] Phone interview 1 was conducted with a management team member
[b] Phone interview 2 was conducted with a family member

5.4.2 Validity

Validity of measurement refers to the extent to which a set of operations measures what it is supposed to measure (e.g., Bohrnstedt, 1983). While reliability focuses on the performance of empirical measures, validity is more theoretically oriented because its adequacy is viewed in relation to the purpose for which it is being used. Good reliability is a necessary, but not a sufficient, condition for good validity. Validity of measurement is often described under three topics: *Criterion-related validity*, *content validity*, and *construct validity* (e.g., Babbie, 1990; Bohrnstedt, 1983; Carmines & Zeller, 1979; Dooley, 1995; Litwin, 1995). Sometimes, *face validity* is regarded as one type of validity. Face validity is a casual assessment of item appropriateness by untrained judges. In the following, criterion-related validity, content validity, and construct validity are discussed in the light of the present study.

Criterion-related validity indicates how well scores of a test relate to another variable, the criterion. The scores of the criterion variable are not directly obtainable, because it would be too expensive or otherwise impracticable, or even impossible. Therefore, the scores of the test are used as a substitute for the criterion. Criterion-related validity is assessed by the correlation between the test measure and the criterion, which is external to the test and which has been previously validated. Unlike content and construct validity, criterion-related validity is empirical in nature because both the test measure and criterion are based on empirical test. Criterion-related validity is broken into *concurrent* and *predictive* types, depending on whether the criterion exists in the present, or whether its future value is predicted.

Criterion-related validity has been used mainly in education and psychology for analyzing various selection processes and tests (Carmines & Zeller, 1979). Its use in survey research has been less because there is lack of empirical criteria against which the validity can be assessed (Bohrnstedt, 1983). That is the case with the present study since the measures are mainly related to theory-based, abstract constructs instead of other empirical variables. Firm performance is assessed in broad categories by using self-reported performance proxies for past performance (control variable), profitability, and growth. Broad firm performance categories are often preferred to accurate and detailed performance data, because executives are unwilling to disclose this information (Chandler & Hanks, 1993). Criterion-related validity could be used to assess the validity of firm performance measures in the present study if correlations between self-reported and objective performance data were available from previous studies. However, this data was not available.

Content validity is a subjective assessment of the appropriateness of measurement items as judged by knowledgeable reviewers. It refers to the degree to which a measure covers the range of meanings included within a concept (e.g., Babbie, 1983). The items selected to measure the concept should represent all the important dimensions of the concept's domain. Content validity is not a quantitative measure, rather it is a qualitative expert opinion. Content validity has limited use because there is no agreed criterion for determining the extent to which a measure has attained content validity. Rather, content validity is regarded as a process that helps to achieve construct validity (Babbie, 1990; Bohrnstedt, 1983). The present study followed the guidelines provided by Bohrnstedt (1983) for enhancing content validity. First, extant literature was searched to determine how other authors have used the concept. Based on this review, the concepts, or constructs, were defined. Second, the domain of the concept was stratified into its major facets and several previously used measurement items were researched and adopted to reflect, whenever possible, the meanings of the different facets. Third, the measurement items were pre-tested with persons similar to those persons to whom the questionnaires were targeted.

Construct validity is concerned with how well a measure reflects a theory-based construct and whether a measure relates to other observed variables in a way that is consistent with theoretically derived predictions (Bagozzi, Yi & Phillips, 1991; Bollen, 1989). Construct validity is sometimes divided into convergent and discriminant validity (Campbell and Fiske, 1959). Convergent validity refers to the degree to which multiple attempts to measure the same concept are consistent, while discriminant validity refers to the degree to which measures of different concepts are distinct. In the present study, construct validity was strengthened and checked by (1) carefully defining constructs and using previously validated measurement items whenever possible, (2) confirmatory factor analysis, and (3) examining correlations between variables (Bohrnstedt, 1983; Bollen, 1989; Carmines & Zeller, 1979).

The confirmatory factor analysis was used to confirm unidimensionality of constructs. Factor analysis identified one construct (factor) for each set of measurement items intended to measure that construct. Also, discriminant validity was supported in three separate factor analyses, in which theoretically derived sets of measurement items were loaded on different factors, according to their construct definitions. As discussed in the construct operationalization section, factor analysis distinguished the following constructs: (1) decision quality, management's decision commitment, and family's decision commitment, (2) board monitoring and board counsel, and (3) social interaction, shared vision, and trust.

Convergent validity is supported by significant correlations between different constructs reflecting a common broader concept. Correlations between the variables are reported in Tables 6.12, 6.17, 6.23, and 6.25 in Chapter 6 when addressing the results of the empirical study. Three social capital constructs, including social interaction, shared vision, and trust, have significant positive correlations between themselves. Family size has a negative relation, although not significantly in two cases, to these social capital variables, as can be expected. Also, family size and number of family institutions in use are significantly related. In the contractual model, board monitoring and board counsel are significant related. Finally, all the three dependent decision-making quality variables have positive and significant correlations. Discriminant validity is supported when two variables correlate significantly with each other, and they correlate significantly differently with at least one third variable. All pairwise significant correlations were examined against this criterion. All those correlations had at least one different correlation with a third variable. These results give further confidence in the construct validity.

The validity of measurement, as discussed above, addressed the question of how the measures correspond to the theoretical, unobserved constructs. Internal validity is concerned about the quality of hypothesized relationships between the constructs. Science is ultimately interested in findings answers to “why” questions, i.e. finding causal relationships among constructs. Usually, three conditions are required for causality: association between constructs, temporal difference between the cause and effect, and exclusion of rival hypotheses. A correlational study can partially support causality by demonstrating association between variables, but it does not reveal the direction of causality. When multivariate techniques, like multiple regression analyses and structural equation modeling, empirically support the hypotheses, then internal validity receives support. Results concerning the hypothesized relationships are presented in the next section. External validity, or generalizability of the results, is discussed in the last section of the study.

6 RESULTS

This chapter presents the results of the analyses for testing the hypotheses of the research model. First, the sample firms are described for the purpose of providing background information for the analysis. The descriptive statistics in the chapter focuses on both the general characteristics and the governance-related features of the firms. Then, the results of regression analyses are presented in four sections. First, the contractual and relational governance models are addressed in separate analyses. Then, the joint effects of the contractual and relational governance mechanisms on decision-making quality are reported. Finally, the relationships between the decision-making variables and firm performance are addressed.

6.1 Descriptive statistics of the sample firms

6.1.1 Age and size

The youngest firm in the sample was six years old, while the oldest was 164. Table 6.1 shows that firm ages since the founding of the firms were relatively evenly distributed within the 1 to 99 year age bracket.

Table 6.1 Age of the sample firms

Age in years since founding	Number of firms	Percent of non-missing
0 to 24	42	22.0
25 to 49	51	26.7
50 to 74	36	18.9
75 to 99	43	22.5
100 to 124	13	6.8
Over 125	6	3.1

N	Mean	Median	Std .dev.	Min	Max	Skewness	Kurtosis
191	56.70	52.00	34.11	6	164	.62	-.01

Some companies were founded before they came under the control of the present family. The respondents were asked in which year the company was founded and since when the company had been under the family's control. In 35 five cases out of 192

(18.2%), family control started after the founding of the company, i.e. the family acquired an existing business. At the time of the acquisition, the average age of the company was 28.2 years. Additionally, in four cases, the respondent did not specify the exact year of acquisition. Thus, approximately one fifth of the companies in the sample were not founded by a member of the owner family, but acquired as an established business.

Size distributions of the sample firms are illustrated in Tables 6.2 and 6.3 in terms of the number of employees and sales revenue in 1999.

Table 6.2 *Size of the sample firms as measured by the number of employees at the end of 1999*

Number of employees	Number of firms	Percent of non-missing
0 to 24	35	19.0%
25 to 49	27	14.7%
50 to 99	31	16.9%
100 to 199	35	19.0%
200 to 499	25	13.6%
500 to 999	17	9.2%
1000 to 1999	7	3.8%
2000 and over	7	3.8%

N	Mean	Median	Std .dev.	Min	Max	Skewness	Kurtosis
184	447.30	98.50	1772.36	2	22600	10.99	135.23

In 1999, the average number of employees was 447.30 and the average sales revenue was € 66.32 million. Both size distributions are skewed towards the small end and have high skewness and kurtosis values. 69.6 % of the companies employed less than 200 employees and 74.8% had sales revenues less than € 50 million. Median values were 98.50 for the employees and € 16.23 million for the sales revenue. Variability of company size was high, as indicated by the standard deviations for both size distributions. The sample included some large family enterprises also. Fourteen companies (7.6%) employed more than 1000 people, while nineteen companies (10.2%) had more than € 150 million sales revenue.

Table 6.3 Size of the sample firms as measured by the sales revenue in 1999

Sales revenue in 1999 Million Euros	Number of firms	Percent of non-missing
0 to 49.9	139	74.8%
50 to 99.9	22	11.8%
100 to 149.9	6	3.2%
150 to 199.9	6	3.2%
Over 200	13	7.0%

N	Mean	Median	Std .dev.	Min	Max	Skewness	Kurtosis
186	66.32	16.23	205.13	.12	2401.12	8.71	92.84

6.1.2 Industries

There were no restrictions placed on the type of industry for the sample firms in the study. Because only corporation form of companies were included in the sample, certain kinds of businesses did not appear. For example, there were no farms because they are commonly carried on as independent trade. Table 6.4 shows the main businesses of the sample firms. The categorization is based on the respondents' own description of the company's main business. The businesses in Table 6.4 are organized so that all businesses involving some kind of production are listed first, then all trading-type businesses are listed, and finally, service businesses are listed. Additionally, three companies were described as multi-business companies by the respondents, called as conglomerates in the table. The sample consists of a versatile mix of businesses. However, it is noteworthy that the sample does not include many companies based on new technologies, like communications technology. This may be due to two reasons. First, family companies may generally operate in more traditional industries. Second, one sampling criterion required that the company had to be at least five years old.

The respondents were also asked to indicate how many distinct industries the company operates in. Responses from 181 companies were received to this question. The results are as follows: 94 companies (52%) operate only in one industry, 37 companies (20%) operate in two industries, 26 companies (14%) operate in three industries, 14 (8%) companies operate in four industries, and 10 companies (6%) operate in five or more industries. These results suggest that the firms in the sample were relatively focused on their main businesses.

Table 6.4 Main businesses of the sample firms

Business	Number of firms	Percentage of firms
Production-related businesses	126	65.6%
Metal and engineering products[a]	36	18.7%
Other manufacturing[b]	17	8.9%
Wood-based products[c]	19	9.9%
Construction and construction materials	14	7.3%
Textile products	12	6.2%
Food production[d]	19	9.9%
Publishing and printing	9	4.7%
Trading-related businesses	36	18.7%
Car retailing	10	5.2%
Technical wholesale	12	6.2%
Other wholesale and retailing	14	7.3%
Service-related businesses	27	14.1%
Transportation[e]	10	5.2%
Services to business[f]	13	6.8%
Services to consumers	4	2.1%
Conglomerate	3	1.6%
Total	192	100%

[a] Machinery, subcontracting and component manufacturing, metal products, steel construction
[b] Electronic equipment, plastic products, small supplies, stone-based products, green-house products
[c] Sawmilling, wood-based panels, furniture, log houses
[d] Multiple products, fresh food, dairy products, bakery products, meat processing, beer and soft drinks
[e] Ground transportation, shipping
[f] Advertising, management consulting, real estate management, accounting, leasing, cleaning

6.1.3 Location of firms

Finland consists of five provinces in mainland Finland and the one semi-autonomous, Swedish speaking province of Åland Islands that lies off the southwest coast of Finland. The total population of Finland is approximately 5.2 million and the total area is 338,000 square kilometers. The sample firms of the study cover all the provinces in Finland, except Åland. Table 6.5 shows the distribution of sample firms among the five provinces. For comparison, the distribution of population is also shown.

The distribution of firms roughly follows the distribution of population of Finland. Southern Finland is the most industrialized and populated province. Also, the Helsinki metropolitan area is located in the province of Southern Finland, often being the location for the head offices of the larger companies in the sample. These facts probably contribute to the high proportion of sample firms (51%) located in Southern Finland.

Table 6.5 Distribution of sample firms among the provinces in Finland

Province	Number of firms	Percent of firms	Population, million	Percent of population
Southern Finland	97	51%	2.08	40%
Western Finland	70	36%	1.84	36%
Eastern Finland	11	6%	.59	11%
Oulu	12	6%	.46	9%
Lapland	2	1%	.19	4%
Total	192		5.16	

6.1.4 Ownership structure

The family is the largest owner group in family business, by definition. Table 6.6 shows how the firm's equity is distributed among different owner groups. The figures are based on data provided by the key informants. The family's average ownership is 92.6% of the total equity. Institutional investors, small outside investors and management all have small equity holdings, the average ranging from 1.3% to 2.2%.

Table 6.6 Ownership structure by owner groups and family's voting power

Statistics	Family's ownership	Management's ownership	Outside small investors	Institutional investors	Other owners	Family's total voting power
N Valid	192	192	192	192	192	191
Missing	0	0	0	0	0	1
Mean	92.6%	1.3%	2.1%	2.2%	1.4%	93.9%
Std. deviation	16.3%	6.5%	7.7%	7.8%	6.2%	13.5%
Minimum	10%	0%	0%	0%	0%	30%
Maximum	100%	68%	59%	50%	49%	100%

Table 6.6 also shows the voting power of the family. The family's average voting power is slightly larger (93.9%) than the family's average ownership (92.6%). The family's

minimum voting power was 30% and maximum 100%. The number of share-owning family members ranged from 1 to 118, having the average value of 7.3 and median of 4.0. 129 companies (67.2%) had one series of shares for all the owners, 59 companies (30.7%) had two series of shares with different voting rights, and 3 companies (1.6%) three series of shares with different voting rights. Ten companies (5.2%) in the sample were publicly listed on the Helsinki Stock Exchange.

6.1.5 Board composition

The composition of the board of directors is broken down into four categories, as shown in Table 6.7. The average size of the board was 4.29 members, ranging from 1 to 11 members. Compared to the other groups, families had the largest representation on the board, on average, 2.86 members. The next largest group on the board consisted of, on average, 1.04 outside members. There were, on average, .35 non-family management team members on the board. A few other board members were reported, mostly representing employees.

Table 6.7 *Board composition*

Statistics	Total board	Family members	Outside members (non-family and non-management)	Management team members but not family members	Other board members
N Valid	191	191	186	187	191
Missing	1	1	6	5	1
Mean	4.29	2.86	1.04	.35	.03
Std. deviation	1.75	1.38	1.26	.80	.23
Minimum	1	0	0	0	0
Maximum	11	10	5	5	2

6.1.6 Leadership pattern

The respondents were asked to indicate which generation of the family was primarily in charge of the family business. Table 6.8 shows that first, second, and third generation leadership are approximately equally represented in the sample, accounting together for 92% of all cases.

Table 6.8 Generation primarily in charge of the family business

Generation	Number of firms	Percent of firms
First	57	29.7%
Second	62	32.3%
Third	58	30.2%
Fourth	11	5.7%
Fifth or more	4	2.1%
Valid total	192	

In 15 cases the respondent indicated that two generations are primarily in charge: first and second generation in 7 cases, second and third generation in 6 cases, and third and fourth generation in 2 cases. It is assumed in the table that the earlier generation is in charge.

It was asked in the questionnaire whether the chairman of the board was a family member, whether the CEO was a family member, and whether the chairman and CEO was the same person. Table 6.9 indicates that the chairman comes from the family in 86.8% of the cases and the CEO comes from the family in 79.7% of the cases. Dual leadership, i.e. the same person holds both the chair and CEO positions, was reported in 21% of the cases. In all dual leadership cases it was a family member who held the both leadership positions.

Table 6.9 Chairman and CEO positions

	Number of firms	Percent of valid
Family chairman	165	86.8%
Non-family chairman	25	13.2%
Valid total	190	
Family CEO	153	79.7%
Non-family CEO	39	20.3%
Valid total	192	
Chairman and CEO are the same person	40	21.0%
Chairman and CEO are different persons	150	79.0%
Valid total	190	

The respondents were asked also how many family members were employed in management and non-management positions. On the average, 1.84 family members held management positions, ranging from 0 to 10. The average for non-management positions was .88 family members, ranging 0 to 20. Figures on board composition and leadership indicate that family members occupied upper managerial positions rather than lower level positions in the organization. This is consistent with the extant family business literature.

6.1.7 Family institutions

The respondents were asked to indicate whether they had a particular family institution in use. Additionally, if they held informal or formal family meetings, they were asked to report how many times annually those meeting were held. In addition to figures given in Table 6.10, 12 companies reported that they had informal family meetings daily, weekly, or "very often." In the statistical analyses, the family institutions scale, from 0 to 4, measures the variety of different institutions used in the family. As is shown later in Table 6.17, the mean value of this measure is 1.27 and the standard deviation 1.01. The most common family institution is the informal family meeting, as can be expected, then the formal family meeting, the family plan, and the least common is the family council. Family councils were generally associated with larger families. Family councils were found in 14 family firms, in which the owner family size ranged from 4 to 118 members, the average being 28.6 members. The average size of the owner family in the sample was 7.3 members. Nine family companies had both the family council and family plan

Table 6.10 Family institutions

	Number of firms	Percent, N=191	Average number of meetings per year when the number was given
Informal family meetings	144	75.4%	7.5 (N=115)
Formal family meetings	49	26.7%	2.3 (N=45)
Family council	14	7.3%	
Family plan	33	17.3%	

6.1.8 Company goals

Family businesses can operate to achieve many different types of goals. The respondents were asked to rate ten goals using a scale from 1 to 7. Anchors in the scale were the following. 1: “Not at all an important goal”; 4: “A rather important goal”; and 7: A very important goal.” Table 6.11 shows the goals and respective statistics.

Table 6.11 Importance of selected goals in family businesses

Goal	Mean	Stand.dev.	N
To maximize sales growth	3.57 (9)	1.33	192
To maximize profitability	5.84 (3)	1.04	192
To maximize return on equity	5.21 (6)	1.23	191
To maximize the firm’s value	4.66 (7)	1.26	190
To be among the top three companies in the main business	5.94 (1)	1.37	191
To continue the firm as a family business	5.55 (4)	1.43	192
To sell the company if an opportunity arises	2.60 (10)	1.46	190
To pay as high dividends as possible	4.20 (8)	1.44	192
To pay steady dividends	5.27 (5)	1.34	192
To provide financial independence to family	5.89 (2)	1.24	192

The number in parenthesis indicates the order of importance

The goal “to be among the top three companies in the main business” had the highest mean value (5.94), followed closely by the goals “to provide financial independence to family” (5.89) and “to maximize profitability” (5.85). Similar to the profitability goal, the goal “to maximize return on equity” was considered only the sixth most important (5.21). The fourth most important goal was “to continue the firm as a family business” (5.55). A similar goal, but stated in negative terms, was “to sell the company if an opportunity arises.” That was considered as the least important goal as indicated by the mean value (2.60). Concerning dividends, it was considered more important “to pay steady dividends” (5.27, rank 5) than “to pay as high dividends as possible” (4.20, rank 8). The goal “to maximize the firm’s value” was considered as the seventh most important goal (4.66). The low ranking of the firm value may reflect the fact that the shares of a family firm are not usually traded on capital markets. Low value may even incur tax benefits to owners. Maximizing sales growth had a low priority compared to other goals (3.57, rank 9).

Goals on profitability and return on equity had the lowest variability as measured by standard deviation. This makes sense because achieving profitability enables the achievement of many other goals. Also goals concerning maximizing the firm value and providing financial independence to the family had relatively low variabilities. The largest variabilities were found in the goals of selling the company, paying high dividends, and continuing the business as a family business. These results are consistent with the existing literature on the difficulties of generational transfer of family businesses (e.g., Aronoff, 1998) and conflicting financial priorities between the family and business (Dreux, 1990). Goals of maximizing sales growth, paying steady dividends, and being among the top three companies in the main business represent medium variability of importance among the goals.

6.1.9 Summary of the descriptive statistics

The sample of family businesses in this study is in line with existing descriptions of family firms found in literature in that they constitute a large variety of companies in terms of their lifecycle phases, types of businesses, and family's involvement in the company (e.g., Brockhaus, 1994; Chua et al., 1999; Donckels & Fröhlich; 1991; Morris et al., 1997; Winter et al., 1998). The descriptive statistics in this section has shown that the sample firms cover many different businesses in the areas of manufacturing, wholesale and retailing, and various services. All the provinces of Finland (excluding the Swedish speaking Åland Islands) are represented in the sample, following roughly the distribution of the population. The majority of the companies, (87%), are located in Southern Finland and Western Finland, where, for example, eight out of the ten largest cities of Finland are located.

The average age of the companies was 56.7 years, ranging from 6 to 164 years. In terms of generational leadership, the first, second, and third generation leadership were relatively evenly distributed, accounting together for 92.2% of the cases. The size of companies varied considerably, spanning from small entrepreneurial setups to large corporations employing thousands of people. However, the size distributions, in terms of sales revenue and the number employees, were skewed towards the small end. This bias is normal in entrepreneurship and strategy research reflecting the size distribution of all enterprises.

The analysis of the importance of ten selected goals of the sample firms suggests that profitability is preferred to company growth and that stable dividends are preferred to paying high dividends. Also, the competitiveness of the business, the family's financial independence, and continuing the business under the family's control had high importance ratings. These results are consistent with the findings of Tagiuri & Davis (1992). As an ownership group, the family was obviously in the dominant position. The family's average ownership share was 92.6% and its voting power 93.9%. As an owner group, the family had 7.3 members on average. Approximately two thirds of the companies had one series of shares and nearly all the remaining companies had two series of shares with different voting rights. Ten companies were listed on the Helsinki Stock Exchange. Family leadership was strongly present in the sample firms: in 86.8% of the cases the chairman of the board came from the family, and in 79.7% of the cases the CEO did so. Additionally, in 21% of the cases a family member held the both positions. The average size of the board was 4.3 members and the family's representation on the board was 2.9 members, on average. All four family institutions were present in the sample: 75.4% of the companies had informal family meetings, 26.7% formal family meetings, 17.3% family plans, and 7.3% family councils.

6.2 Contractual governance model

It was hypothesized in the contractual governance model that the family's decreasing inside ownership is associated with an increasing proportion of outside board members. Increasing outside representation was hypothesized to be associated with increasing board monitoring and board counsel activities. Finally, higher levels of these board activities were hypothesized to be related to a higher strategic decision-making quality in terms of decision quality and decision commitment. The model features seven direct relationship hypotheses and two mediating effects hypotheses.

6.2.1 Correlations among the variables

Correlation coefficients as well as means and standard deviations of the variables in the contractual governance model are displayed in Table 6.12. There are several significant correlations in the table. All the statistically significant correlations are briefly discussed below. In line with the proposed model, decision quality and management's decision commitment are both positively correlated to board monitoring and board counsel. Inside ownership is negatively associated with board composition and board monitoring; this is also in line with the model. Board monitoring and board counsel are positively correlated. This is consistent with the model, because both these board function variables have a common antecedent, which is board composition. Similarly, decision quality and management's decision commitment are correlated. In the model, they also have common antecedents. Board composition is correlated with board monitoring, as the model implies.

Firm size and generation in charge both reflect the lifecycle phase of the company. They are positively correlated with board composition and negatively correlated with inside ownership, as can be expected. Also, firm size is positively correlated with both board functions, i.e. monitoring and counsel. Firm size and generation in charge are positively correlated, as can be expected.

Dual leadership and family's voting control are important governance variables in the model; they are correlated, as can expected. Both of the variables have partly similar correlations with other variables: a positive correlation with family's inside ownership and negative correlations with board composition and firm size. These results are consistent with received governance literature. Also, dual leadership is negatively correlated with board monitoring and generation in charge, but positively correlated with management's decision commitment.

Interestingly, past performance is positively correlated with inside ownership and dual leadership but negatively correlated with generation in charge and firm size. These results suggest that smaller and younger family enterprises, where the separation of ownership from control has not yet occurred, at least not significantly, are more profitable.

Table 6.12 Means, standard deviations, and Pearson correlation coefficients between the variables in the contractual governance model

	Mean	s.d.	1	2	3	4	5	6	7	8	9	10	11
1 Decision quality	5.87	.73											
2 Management's decision commitment	6.02	.76	.51**										
3 Inside ownership	.79	.27	-.10	.01									
4 Board composition	.21	.25	.01	-.14	-.38**								
5 Board monitoring	4.95	1.44	.31**	.16*	-.23**	.38**							
6 Board counsel	4.56	1.25	.32**	.30**	-.04	.13	.50**						
7 Generation	2.18	.99	-.08	.02	-.25**	.26**	.14	-.04					
8 Firm size[a]	1.90	.77	.08	-.04	-.32**	.33**	.30**	.15*	.37**				
9 Past performance	2.17	1.08	.10	.07	.19*	-.08	.03	.04	-.15*	-.25**			
10 Dual leadership	.21	.41	.02	.15*	.29**	-.30**	-.19**	-.05	-.23**	-.32**	.17*		
11 Voting control	.94	.14	-.13	.03	.51**	-.35**	-.12	-.01	.03	-.24**	.09	.15*	
12 Environmental turbulence	4.15	1.41	-.06	-.05	-.18*	.16*	.00	.16*	.12	.08	-.12	-.15*	-.07

[a] Variable is a logarithm
** p < .01; * p <.05; two-tailed test

Environmental turbulence is positively correlated with outside members' representation on the board and with the level of board counsel. This is in line with arguments that complexity and uncertainty of strategic decision-making task need to be matched with the requisite variety of information in the decision-making process. Also consistent with the same argument, increasing environmental turbulence is correlated negatively with inside ownership and dual leadership. In the other words, the more complex businesses seem to require higher amount of outside professionals on the board and management, and separation of board and CEO positions.

6.2.2 Regression analyses

To test Hypotheses 1 to 7, regressions were carried out in five separate regression tests. The results are displayed in Table 6.13, including both hypothesized relationships and control variables' effects on the contractual model's dependent variables. Each column shows the independent and control variables' standardized beta coefficients with their respective significance levels. The independent and control variables' multicollinearity was no problem in any of the regression equations. This is indicated by low variance inflation factors VIF values. The highest value of VIF was 1.54, as shown in Table 6.13. As discussed in the methodology section, VIF values exceeding 10 indicate harmful multicollinearity among the independent variables.

Hypothesis 1 is supported in Test 1 in Table 6.13. As the family's inside ownership (share of equity of those family members who are either on the board or in top management) decreases, the proportion of outside board members (members who are not part of the family nor the management) increases (beta=-.15, $p<.05$). Test 1 also shows three significant control variable effects on board composition. Generation in charge has significant positive effect on the board composition (beta=.15, $p<.05$), whereas dual leadership (beta=-.15, $p<.05$) and the family's voting control (beta=-.23, $p<.01$) have negative relationships with the proportion of outside board members.

Test 2 shows that Hypothesis 2 receives very strong support. The level of the board's monitoring activities on management is associated with board composition (beta=.33, $p<.001$). Also, one significant control variable effect is indicated by Test 2: firm size has a positive effect on board monitoring (beta=.21, p<.01). Hypothesis 3 receives marginal support in Test 3, suggesting that board composition and board counsel are positively associated (beta=.12, p<.1). Of the control variables in Test 3, generation in charge is marginally and negatively associated with board counsel (beta=-.14, p<.1) whereas firm size (beta=.19, p<.05) and environmental turbulence (beta=.16, p<.05) have a positive relationship with board counsel.

Table 6.13 Contractual governance mechanisms and decision-making quality

Variables	Board composition	Board monitoring	Board counsel	Decision quality	Management's decision commitment
	Test 1	Test 2	Test 3	Test 4	Test 5
Independent variables:					
Inside ownership	-.15*				
Board composition		.33***	.12†		
Board monitoring				.20**	.03
Board counsel				.22**	.32***
Control variables:					
Generation	.15*	-.01	-.14†	-.08	.11
Firm size	.12	.21**	.19*	.03	-.08
Past performance	.04	.11	.09	.07	.02
Dual Leadership	-.15*	-.07	.01	.06	.16*
Voting control	-.23**	.04	.08	-.11	-.02
Environmental turbulence		-.06	.16*	-.07	-.09
Adjusted R^2	.23	.17	.04	.13	.10
F	10.28***	6.43***	2.16*	4.63***	3.53**
Max VIF	1.54	1.36	1.36	1.50	1.50

Missing values replaced with means; one-tailed tests for standardized beta weights in hypotheses, otherwise two-tailed tests; † p < .1, * p <.05, ** p < .01, *** p <.001

Hypotheses 4 and 6 receive strong support in Test 4. Both the board functions, i.e. high levels of board monitoring (beta=.20, p<.01) and board counsel (beta=.22, p<.01) are associated with high decision quality. No significant control variable effects were indicated in Test 4.

Hypothesis 5, which stated that board monitoring is positively related to management's decision commitment, is not supported in Test 5. Hypothesis 7 is strongly supported in Test 5. Board counsel is positively associated with management's decision commitment (beta=.32, $p<.001$). Test 5 also indicates one significant control variable association. Dual leadership is positively associated with management's decision commitment (beta=.16, $p<.05$).

In sum, out of seven direct effects hypotheses in the contractual governance model, five were supported, one was marginally supported ($p<.1$), and one hypothesis was not supported. Five control variables had significant associations in Tests 1 to 5: generation in charge, firm size, and dual leadership had two significant relationships, while voting control and environmental turbulence had one significant relationship. Past performance had no effect in any sub-model in the contractual governance model.

The values of the adjusted multiple coefficients of determination R^2 varied from .04 to .23, as shown in Table 6.13. Test 3 had the lowest R^2 (.04), indicating that variance of board composition and control variables explain only a small amount of the variation in board counsel. The highest R^2 (.23) was present in Test 5, testing the effects on board composition. An F test was used to test if the regression was significant as a whole. Table 6.13 shows that all regression equations have statistically significant F-ratios, indicating good overall model adequacy.

The contractual governance model has two hypotheses for mediating relationships. The mediating relationships are tested in stages, as discussed in the methodology section. Table 6.14 shows the regressions for testing Hypothesis 8, which stated that board composition mediates the effects of inside ownership on board monitoring and on board counsel. Because analyses for testing mediating effects involve the same control variables as the direct effects analyses above, their results are not reported in Table 6.14.

Tests 1a and 1b are for testing whether board composition mediates the relationship between inside ownership and board monitoring. In the first stage, only inside ownership is entered. Test 1a shows that inside ownership is significantly and negatively associated with board monitoring, fulfilling one condition for mediation. In the second stage, board composition is also entered into the equation. Test 1b shows that the significance level of inside ownership has decreased to a marginal significance level (p<.1), while board composition is significantly associated with board monitoring. For full mediation, inside ownership should not have a significant beta coefficient in Test 1b. Together, Tests 1a and 1b support part of Hypothesis 8: board composition mediates, at least partially, the effects of inside ownership on board monitoring.

Table 6.14 Mediating effects of board composition

Variables	Board monitoring Test 1a	Board monitoring Test 1b	Board counsel Test 2a	Board counsel Test 2b
Independent variables:				
Inside ownership	-.16*	-.12†	-.02	-.01
Board composition		.32***		.12†
Adjusted R^2	.10	.17	.03	.04
F	3.96***	5.92***	1.85†	1.88†

Missing values replaced with means; one-tailed tests for standardized beta weights in hypotheses, otherwise two-tailed tests; † p < .1, * p <.05, ** p < .01, *** p <.001

Tests 2a and 2b in Table 6.14 fail to support the second part of Hypothesis 8 that states that board composition mediates the effects of inside ownership on board counsel. Inside ownership is not significantly associated with board counsel in Test 2a, ruling out the possibility of mediation. In sum, Hypothesis 8 is partially supported.

Hypothesis 9 stated that board monitoring and board counsel mediate the effects of board composition on decision-making quality variables. Testing of Hypothesis 9 is split into Tables 6.15 and 6.16. Effects on decision quality are shown Table 6.15. Board composition does not have a significant relationship with decision quality when board monitoring and board counsel are not entered into the equation, as shown in Test 1a. This is sufficient for ruling out the possibility that board monitoring and board counsel together mediate the relationship between board composition and decision quality. Tests 1c and 1d suggest that board counsel partially mediates a negative relationship between board composition and decision quality when board monitoring is controlled for. This is indicated by the significance level of beta coefficient of board composition decreasing from Test 1d to 1c, and board counsel's significant beta coefficient in Test 1c. Tests 1b and 1c indicate no mediating relationship between board monitoring and decision quality when board counsel is entered as a control variable. Thus, the first part of the Hypothesis 9 is not supported.

Table 6.15 Mediating effects of board monitoring and board counsel on decision quality

	Decision quality			
	Test 1a	Test 1b	Test 1c	Test 1d
Independent variables:				
Board composition	-.02	-.06	-.13†	-.14*
Board monitoring			.24**	.35***
Board counsel		.33***	.22**	
Adjusted R^2	.01	.11	.14	.11
F	1.30	3.88***	4.43***	3.95***

Missing values replaced with means; one-tailed tests for standardized beta weights in hypotheses, otherwise two-tailed tests; † p < .1, * p <.05, ** p < .01, *** p <.001

Table 6.16 shows the regressions for testing mediating relationships on management's decision commitment.

Table 6.16 Mediating effects of board monitoring and board counsel on management's decision commitment

	Management's decision commitment			
	Test 1a	Test 1b	Test 1c	Test 1d
Independent variables:				
Board composition	-.13†	-.17*	-.20**	-.22**
Board monitoring			.09	.26***
Board counsel		.35***	.31***	
Adjusted R^2	.01	.12	.12	.06
F	1.12	4.21***	3.88***	2.40*

Missing values replaced with means; one-tailed tests for standardized beta weights in hypotheses, otherwise two-tailed tests; † p < .1, * p <.05, ** p < .01, *** p <.001

Tests 1a and 1c indicate that board monitoring and board counsel do not together mediate the relationship between board composition and management's decision commitment. Also, board monitoring does not mediate the relationship between board composition and management's decision commitment when board counsel is controlled for, as indicated by Tests 1b and 1c. Similarly, board counsel does not mediate effects of board composition on management's decision commitment when board monitoring is controlled for. Interestingly, all four regressions in Table 6.16 indicate a negative and significant relationship between board composition and management's decision commitment. Results from Tables 6.15 and 6.16 do not support Hypothesis 9.

6.3 Relational governance model

Hypotheses in the relational governance model posited that the variety of family institutions and family size are related to social interaction among the family members, which in turn affects the levels of shared vision and trust. Finally, higher levels of shared vision and trust were hypothesized to be associated with strategic decision-making qualities. The relational governance model has ten direct effects hypotheses and two mediating effects hypotheses.

6.3.1 Correlations among the variables

The relational governance model shares some variables with the contractual model. They have two common dependent variables and five common control variables. Table 6.17 displays means, standard deviations and correlations among the variables in the relational governance model. Significant correlations are briefly discussed below. Discussions concerning the common variables among the contractual and relational models governance can be found in Section 6.2.1, and are not repeated here.

Consistent with the relational model, social capital variables have several significant correlations among themselves. Family size is negatively correlated with social interaction. The number of different family institutions in use is correlated with family size and with social interaction. Trust and shared vision are both correlated with social interaction. Finally, shared vision and trust are correlated. In addition, all the five social capital variables (family institutions, family size, social interaction, shared vision, and trust) are correlated with at least one decision-making variable, but in most cases with all three (decision quality, management's decision commitment, and family's decision commitment). The three decision-making variables were correlated among themselves.

Control variables have numerous correlations with social capital variables. Generation in charge is positively correlated with family institutions and family size and negatively correlated with social interaction action and shared vision. Firm size is also positively correlated with family institutions and family size and negatively correlated with social interaction action. Further, dual leadership is negatively related to family size. Interestingly, the number of family members on board is positively correlated with the number of family institutions in use, family size, and firm size. Also, the number of family members on board and and family's decision commitment are correlated, as can be expected. Inside ownership is positively correlated with family's decision commitment, social interaction, and shared vision but negatively correlated with family institutions and family size.

Table 6.17 Means, standard deviations, and Pearson correlation coefficients between the variables in the relational governance model

	Mean	s.d.	1	2	3	4	5	6	7	8	9	10	11	12	13	14
1 Decision quality	5.87	.73														
2 Manag. decision commitment	6.02	.76	.51**													
3 Family's decision commitment	5.48	1.10	.38**	.39**												
4 Family institutions	1.27	1.01	.15*	.08	.28**											
5 Family size	7.30	12.12	.17*	.10	.05	.39**										
6 Social interaction	5.84	1.10	.19**	.29**	.41**	.17*	-.16*									
7 Shared vision	5.45	1.01	.31**	.33**	.59**	.12	-.09	.44**								
8 Trust	6.14	.83	.24**	.40**	.17*	-.10	-.02	.28**	.35**							
9 Generation	2.18	.99	-.08	.02	.01	.14*	.28*	-.23**	-.15*	.05						
10 Firm size[a]	1.90	.77	.08	-.04	-.04	.33*	.29*	-.16*	-.07	-.08	.38**					
11 Past performance	2.17	1.08	.10	.07	.12	.03	.01	.03	.14	-.06	-.15*	-.25**				
12 Dual leadership	.21	.41	.02	.15*	-.05	-.12	-.17*	.11	.06	.02	-.23**	-.32**	.17*			
13 Family members on board	2.86	1.38	-.01	.00	.16*	.24**	.36**	-.08	.08	.05	.12	.25**	-.09	-.12		
14 Inside ownership	.79	.27	-.10	.01	.16*	-.18*	-.47**	.20**	.17*	-.02	-.25**	-.32**	.19*	.29**	.05	
15 Environmental turbulence	4.15	1.41	-.06	-.05	.03	.06	.09	.07	.02	-.02	.12	.08	-.12	-.15*	.05	-.18*

[a] Variable is a logarithm
** p < .01; * p <.05; two-tailed test

6.3.2 Regression analyses

Regressions for testing Hypotheses 10 to 19 were carried out in six separate regression tests, which are displayed in Table 6.18. Similarly, as in the contractual governance model, multicollinearity was no problem in regressions because variance inflation factors VIF were at low levels, as shown in Table 6.18. Maximum VIF is 1.55, which is well below a threshold value of 10 for harmful collinearity among independent variables.

Test 1 in Table 6.18 shows that Hypothesis 10 is strongly supported and Hypothesis 11 marginally supported. Hypothesis 10 argued that as the number of different family institutions increases, the level of social interaction among the family members increases also (beta=.33, p<.001). Hypothesis 11 posited that increasing owner family size is negatively associated with social interaction (beta=-.13, p<.1). One control variable has significant and one marginally significant beta coefficient: generation in charge is negatively associated with social interaction (beta=-.16, p<.05) and inside ownership positively is associated with social interaction (beta=.15, p <.1).

Hypotheses 12 and 13, which suggested that increased social interaction would lead to greater shared vision among the owner family members (beta=.41, p<.001) and increased level of trust among the owner and management (beta=.31, p<.001), are strongly supported, as shown in Test 2 and Test 3 in Table 6.18. Past performance (beta=.13, p<.1) and number of family members on board (beta=.12, p<.1) are marginally associated with shared vision. Generation in charge (beta=.13, p<.1) is marginally, and firm size marginally and negatively, associated with trust (beta=-.14, p<.1).

Decision quality was proposed to be associated with shared vision in Hypothesis 14 and with trust in Hypothesis 17. Both hypotheses are supported, as shown in Test 4 in Table 6.18 (beta=.26, p<.001 for shared vision and beta=.17, p<.05 for trust). Of the control variables, both firm size (beta=-.15, p<.1) and inside ownership (beta=-.16, p<.05) are negatively related to decision quality.

Tests 5 and 6 indicate effects on decision commitment. As stated in Hypothesis 15, management's decision commitment is associated with shared vision (beta=.23, p<.01), and, as stated in Hypothesis 18, management's decision commitment is associated with trust, (beta=.31, p<.001). Dual leadership, acting as a control variable in Test 5, is associated with management's decision commitment (beta=.16, p<.05). Hypothesis 16, arguing that shared vision is linked to family's decision commitment, receives strong support (beta=.59, p<.001). Hypothesis 19 did not receive support: trust is not linked to family's decision commitment. Two control variable effects are marginally significant (for both, beta=.11, p<.1) in Test 6: both generation in charge and the number of family members on board are associated with family's decision commitment.

Table 6.18 Relational governance mechanisms and decision-making quality

Variables	Social interaction	Shared vision	Trust	Decision quality	Management's decision commitment	Family's decision commitment
	Test 1	Test 2	Test 3	Test 4	Test 5	Test 6
Independent variables:						
Family institutions	.33***					
Family size	-.13†					
Social interaction		.41***	.31***			
Shared vision				.26***	.23**	.59***
Trust				.17*	.31***	-.05
Control variables:						
Generation	-.16*	-.05	.13†	-.11	.07	.11†
Firm size	-.12	.04	-.14†	-.15†	.03	-.06
Past performance	-.06	.13†	-.06	.10	.05	.05
Dual Leadership	.01	-.01	.02	.04	.16*	-.09
Family on board	-.08	.12†	.09	-.03	-.02	.11†
Inside ownership	.15†	.06	-.09	-.16*	-.06	.09
Environmental turbulence				-.06	-.04	.02
Adjusted R^2	.13	.19	.08	.13	.19	.35
F	4.50***	7.20***	3.26***	4.12***	5.96***	12.25***
Max VIF	1.55	1.36	1.36	1.39	1.39	1.39

Missing values replaced with means; one-tailed tests for standardized beta weights in hypotheses, otherwise two-tailed tests; † p < .1, * p <.05, ** p < .01, *** p <.001

In sum, hypotheses on social capital variables and their effects on strategic decision-making quality are well supported in the relational governance model. Of the ten hypotheses, eight were significantly supported, one was marginally supported ($p<.1$), and one was not supported. Comparing effects of shared vision and trust on the three decision-making quality variables, shared vision performed slightly better than trust (Tests 4, 5, and 6). As discussed above, there were several control variable effects. In Tests 1 to 6, generation in charge had three significant relationships; firm size, the number of family members on board, and inside ownership had two significant relationships; past performance, and dual leadership had one significant relationship. Environmental turbulence had no effect on decision-making quality. The adjusted multiple coefficient of determination R^2 varied from .08 (Test 3) to .35 (Test 6), indicating the amount of variation in dependent variables explained by independent and control variables. All the tests had statistically significant F-ratios indicating good statistical significance for the sub-models.

The relational governance model has two hypotheses for mediating effects. Control variables are same as those in Table 6.18, but they not discussed in the mediating relationship analyses below. Table 6.19 shows the results of testing Hypothesis 20, which posited that social interaction mediates effects of family institutions and family size on shared vision and trust. Tests 1a and 1b support this hypothesis. In the first stage (Test 1a), family institutions is positively associated, and family size is negatively associated, with shared vision. Family size is only marginally associated ($p <.1$) with shared vision. This result is in line with the result of Hypothesis 11, in which family size was negatively and marginally associated with social interaction. When social interaction is entered in the second stage (Test 1b), beta coefficients for family institutions and family size become non-significant, while social interaction is significantly associated to shared vision. Thus, social interaction fully mediates the relationship between family institutions and family size, and shared vision.

Other parts of Hypothesis 20 are not supported, as indicated by Tests 2a and 2b. Family institutions and family size have not significant relationship with trust. Interestingly, when social interaction is entered in the second stage (2b), the relationship between family institutions and trust becomes significantly negative. In sum, Hypothesis 20 is partially supported.

Table 6.19 Mediating effects of social interaction

Variables	Shared vision		Trust	
	Test 1a	Test 1b	Test 2a	Test 2b
Independent variables:				
Family institutions	.17*	.04	-.09	-.21**
Family size	-.12†	-.07	-.03	.02
Social interaction		.40***		.36***
Adjusted R^2	.05	.18	0	.10
F	2.17*	5.66 ***	.77	3.33***

Missing values replaced with means; one-tailed tests for standardized beta weights in hypotheses, otherwise two-tailed tests; † p < .1, * p <.05, ** p < .01, *** p <.001

Hypothesis 21 posited that shared vision and trust mediate the effects of social interaction decision-making quality. This hypothesis has three parts corresponding to the three decision-making quality variables; Tables 6.20 to 6.22 show the respective results. Table 6.20 shows the tests for mediating effects on decision quality. Tests 1a and 1c indicate that shared vision and trust, together, fully mediated the relationship between social interaction and decision quality. Also, shared vision fully mediates the relationship between social interaction and decision quality when trust is controlled for, as shown in Tests 1b and 1c. Finally, trust partially mediates the relationship between social interaction and decision quality when shared vision is controlled for as shown in Tests 1c and 1d.

Table 6.20 Mediating effects of shared vision and trust on decision quality

Variables	Decision quality			
	Test 1a	Test 1b	Test 1c	Test 1d
Independent variables:				
Social interaction	.22**	.16*	.08	.11†
Shared vision			.23**	.28***
Trust		.22**	.15*	
Adjusted R^2	.06	.09	.13	.12
F	2.40*	3.19**	3.82***	3.73***

Missing values replaced with means; one-tailed tests for standardized beta weights in hypotheses, otherwise two-tailed tests; † p < .1, * p <.05, ** p < .01, *** p <.001

Tests 1a and 1c in Table 6.21 suggest that shared vision and trust partially mediate the relationship between social interaction and management's decision commitment. The mediation is not full because social interaction still has a significant beta coefficient, although at a reduced level. When trust is controlled for, Tests 1b and 1c show that a shared vision partially mediates social interaction on management's decision commitment. Similarly, Tests 1d and 1c show that trust partially mediates social interaction on management's decision commitment when shared vision is controlled for.

Table 6.21 Mediating effects of shared vision and trust on management's decision commitment

Variables	Management's decision commitment			
	Test 1a	Test 1b	Test 1c	Test 1d
Independent variables:				
Social interaction	.32***	.22**	.16*	.21**
Shared vision			.17*	.26***
Trust		.34***	.29***	
Adjusted R^2	.09	.19	.21	.14
F	3.28**	5.88***	5.92***	4.44***

Missing values replaced with means; one-tailed tests for standardized beta weights in hypotheses, otherwise two-tailed tests; † p < .1, * p <.05, ** p < .01, *** p <.001

Table 6.22 Mediating effects of shared vision and trust on family's decision commitment

Variables	Family's decision commitment			
	Test 1a	Test 1b	Test 1c	Test 1d
Independent variables:				
Social interaction	.45***	.41***	.25***	.23***
Shared vision			.50***	.47***
Trust		.05	-.09†	
Adjusted R^2	.21	..21	.39	.39
F	7.28***	6.51***	13.30***	14.46***

Missing values replaced with means; one-tailed tests for standardized beta weights in hypotheses, otherwise two-tailed tests; † p < .1, * p <.05, ** p < .01, *** p <.001

Finally, Table 6.22 shows that shared vision and trust only weakly mediate the relationship between social interaction and family's decision commitment. Social interaction is significantly associated with family's decision commitment in all tests in Table 6.22. Weak mediation is supported by the reduced values of social interaction in Tests 1b, 1c, and 1d compared to 1a. Taking together the results from Tables 6.20 to 6.22, Hypothesis 21 is partially supported.

6.4 Joint effects of contractual and relational governance mechanisms on decision-making quality

6.4.1 Correlations among the variables

Table 6.23 displays the correlations among the variables in the joint effects model. In addition to earlier reported correlations, there are two significant correlations. Shared vision is positively correlated with board monitoring and board counsel.

Table 6.23 Means, standard deviations, and Pearson correlation coefficients between the variables in the joint effects model

	Mean	s.d.	1	2	3	4	5	6	7	8	9	10	11	12	13
1 Decision quality	5.87	.73													
2 Management's decision commitment	6.02	.76	.51**												
3 Board monitoring	4.95	1.44	.31**	.16*											
4 Board counsel	4.56	1.25	.32**	.30**	.50**										
5 Shared vision	5.45	1.01	.31**	.33**	.27**	.36**									
6 Trust	6.14	.83	.24**	.40**	.08	.03	.35**								
7 Generation	2.18	.99	-.08	.02	.14	-.04	-.15*	.05							
8 Firm size[a]	1.90	.77	.08	-.04	.30**	.15*	-.07	-.08	.37**						
9 Past performance	2.17	1.08	.10	.07	.03	.04	.14	-.06	-.15*	-.25**					
10 Dual leadership	.21	.41	.02	.15*	-.19**	-.05	.06	.02	-.23**	-.32**	.17*				
11 Voting control	.94	.14	-.13	.03	-.12	-.01	.09	.02	.03	-.24**	.09	.15*			
12 Family members on board	2.86	1.38	-.01	.00	-.02	.01	.08	.05	.12	.25**	-.09	-.12	.23**		
13 Inside ownership	.79	.27	-.10	.01	-.23**	-.04	.17*	-.02	-.25**	-.32**	.19*	.29**	.51**	.05	
14 Environmental turbulence	4.15	1.41	-.06	-.05	.00	.16*	.02	-.02	.12	.08	-.12	-.15*	-.07	.05	-.18*

[a] Variable is a logarithm
** p < .01; * p <.05; two-tailed test

6.4.2 Regression analyses

Table 6.24 shows the results of the joint effects of the contractual and relational governance variables on decision quality and management's decision commitment. Control variables include all control variables combined from the contractual and relational governance models. Family's decision commitment is not included in the analysis because it is not part of the contractual model.

Table 6.24 Joint Effects on Decision-Making Quality

Variables	Decision quality			Management's decision commitment		
	Test 1a	Test1b	Test 1c	Test 2a	Test2b	Test 2c
Independent variables:						
Board monitoring	.19*		.14*	.03		-.04
Board counsel	.23**		.19*	.32***		.28***
Shared vision		.26***	.14*		.23**	.13*
Trust		.16*	.18**		.32***	.37***
Control variables:						
Generation	-.09	-.10	-.09	.10	.06	.09
Firm size	.01	.13	.06	-.09	.03	-.02
Past performance	.08	.10	.08	.02	.05	.04
Dual Leadership	.07	.04	.06	.17*	.16*	.15*
Voting control	-.10	-.07	-.09	-.01	.02	.00
Family members on board	.05	-.02	.02	.04	-.02	-.01
Inside ownership	-.06	-.13	-.08	-.04	-.07	-.06
Environmental turbulence	-.08	-.06	-.08	-.09	-.04	-.08
Adjusted R^2	.13	.13	.18	.09	.19	.24
Differences 1[a]						
Δ Adjusted R^2			.05			.15
Δ F			7.30**			18.75***
Differences 2 [b]						
Δ Adjusted R^2			.05			.05
Δ F			7.31**			7.27**

Missing values replaced with means; one-tailed tests for standardized beta weights in hypotheses, otherwise two-tailed tests; † $p < .1$, * $p < .05$, ** $p < .01$, *** $p < .001$
[a] Test1c vs. Test1a and Test2c vs. Test2a
[b] Test1c vs. Test1b and Test2c vs. Test2b

The analysis is structured as two sets of analogical analyses. In the first set, the full model, i.e. the model including both contractual and relational independent variables (board monitoring, board counsel, shared vision, and trust), is compared to the model including only contractual independent variables. In the second set, the full model is compared to the model including only relational independent variables. In both cases, it is analyzed to discover whether the full model will fit the data better than the model with removed variables. If the full model explains the data better, then the complementary nature of contractual and relational governance receives support.

Test 1c for the joint effects on decision quality repeats the earlier results, showing that board monitoring, board counsel, shared vision, and trust are all positively related to decision quality, as hypothesized. Test 1a tests the effects of contractual variables on decision quality, and Test 1b tests the effects of relational variables. Test 1c has a larger adjusted multiple coefficient of determination R^2 than either Test 1a or 1b. The difference in adjusted R^2 is in both cases .05. These results indicate that the independent variables in Test 1c explain more variation in decision quality than Test 1a or Test 1b alone. Differences in F-ratios (7.30 for Test 1c versus 1a and 7.31 for Test 1c versus 1b) are significant at level $p<.01$., supporting the view that the joint effects model in Test 1c is more adequate as a whole than the model in Tests 1a or 1b.

The adequacy of the joint effects on management's decision commitment is tested in a similar vein. First, Test 2c repeats the earlier results from the contractual and relational governance models: board counsel, shared vision, and trust are positively related to decision commitment, as hypothesized. Board monitoring was found to be negatively and non-significantly related to management's decision commitment, which is against the expectations of Hypothesis 5. Test 2c has a larger adjusted R^2 than either Test 2a or 2b. The difference is .15 when compared to Test 2a and .05 when compared to 2b. Differences in F-ratios are 18.75 at level $p<.001$, and 7.27 at level $p<.01$, respectively. The results indicate that Test 2c explains more variation in decision commitment than Test 2a or Test 2b alone. In sum, the results above support the Hypothesis 22, which proposed that contractual and relational governance mechanisms have a complementary effect on decision-making quality.

6.5 Decision-making quality and firm performance

6.5.1 Correlations among the variables

Table 6.25 shows some new significant correlations. Profitability and growth are significantly correlated. This is in line with the common argument that family firms have scarce financing opportunities. A typical way to finance growth is utilize retained earnings, which are the result of past profitability. Consistent with the model, profitability is positively correlated with decision quality and management's decision commitment, and growth is positively correlated with decision quality and family's decision commitment. Profit orientation is negatively correlated with growth. This result is quite obviously, because profitability and growth are often at least partially competing goals. Generation in charge and growth orientation are negatively correlated. As can be expected, environmental turbulence is negatively correlated with both profitability and growth. Interestingly, environmental turbulence and growth orientation are positively correlated.

Table 6.25 Means, standard deviations, and Pearson correlation coefficients between decision-making quality and firm performance variables

	Mean	s.d.	1	2	3	4	5	6	7	8	9
1 Profitability[a]	.00	.93									
2 Growth[a]	.00	.89	.46**								
3 Decision quality	5.87	.73	.22**	.19**							
4 Management's decision commitment	6.02	.76	.15*	.09	.51**						
5 Family's decision commitment	5.48	1.10	.11	.15*	.38**	.39**					
6 Generation	2.18	.99	-.08	-.09	-.08	.02	.01				
7 Firm size[b]	1.90	.77	.04	.13	.08	-.04	-.04	.37**			
8 Profit orientation[a]	.00	.83	-.04	-.20**	.07	.12	.03	-.11	-.04		
9 Growth orientation[a]	.00	.87	-.01	.09	.08	.07	.03	-.16*	.03	-.04	
10 Environmental turbulence	4.15	1.41	-.15*	-.17*	-.06	-.05	.03	.12	.08	.02	.17*

[b] Variable is a logarithm
[a] Index is based on standardized item values
** $p < .01$; * $p < .05$; two-tailed test

6.5.2 Regression analyses

Hypotheses 23a, 24a, 25a stated that higher decision-making quality is associated with higher profitability. Results for these hypotheses are shown in Test 1 in Table 6.26, where all the three independent decision-making variables are entered simultaneously. Hypothesis 23a, arguing that decision quality is associated with profitability, is supported (beta=.16, p<.05). Hypotheses as to effects of management's decision commitment (Hypothesis 24a) and family's decision commitment (Hypothesis 25a) on profitability are not supported in Test 1. Environmental turbulence, a control variable, is marginally negatively associated with profitability (beta=-.13, p<.1).

Table 6.26 Decision-making quality and profitability

Variables	Profitability						
	Test 1	Test 2	Test 3	Test 4	Test 5	Test 6	Test 7
Independent variables:							
Decision quality	.16*	.21**				.17*	.19*
Management's decision commitment	.06		.16*		.13*	.07	
Family's decision commitment	.04			.12*	.07		.05
Control variables:							
Generation	-.08	-.07	-.10	-.10	-.10	-.08	-.07
Firm size	.06	.05	.09	.09	.09	.06	.06
Profit orientation	-.07	-.06	-.07	-.05	-.07	-.07	-.06
Environmental turbulence	-.13†	-.13†	-.13†	-.15*	-.14†	-.13†	-.13†
Adjusted R^2	.05	.05	.03	.02	.03	.05	.05
F	2.31*	3.06*	2.30*	1.88†	2.06†	2.67*	2.61*
Max VIF	1.49	1.19	1.18	1.18	1.21	1.40	1.22

Missing values replaced with means; one-tailed tests for standardized beta weights in hypotheses, otherwise two-tailed tests; † p < .1, * p <.05, ** p < .01, *** p <.001

Tests 2 to 4 indicate that, when all three decision-making variables are entered alone in separate analyses, their beta coefficients are significant. Tests 3 and 6 suggest that decision quality mediates the relationship between management's decision commitment and profitability. To further test this mediation, decision quality was regressed on management's decision commitment and to all the same control variables as shown in Table

6.26. Management's decision commitment was significantly related to decision quality (beta = .52, $p<.001$), supporting the mediation. Similarly, Test 4 and 7 suggest that decision quality mediates the relationship between family's decision commitment and profitability. Family's decision commitment was significantly related to decision quality (beta = .39, $p<.001$), supporting the mediation. When decision quality is excluded from the analysis, management's decision commitment is significantly associated with profitability but family's decision commitment is not, as indicated in Test 5. In a step-wise analysis, Tests 5 and 1 indicate that decision quality mediates the relationship between management's decision commitment and profitability, but does not mediate the relationship between family's decision commitment and profitability. In sum, decision quality is associated with profitability directly, but both management's and family's decision commitment are only indirectly related to profitability, mediated by decision quality. Finally, management's decision commitment is slightly more strongly related to profitability, as beta coefficients and their significance levels, and mediation analyses above suggest.

Hypotheses 23b, 24b, and 25b posit that the three decision-making variables are positively associated with company growth. As Test 1 in Table 6.27 shows, decision quality (beta=.11, $p<.1$) and family's decision commitment (beta=.13, $p<.1$) are marginally related to growth, supporting Hypotheses 23b and 25b. Hypothesis 24b, stating that management's decision commitment and growth are associated, is not supported in Test 1. Of the control variable effects, firm size was positively related (beta=.17, $p<.05$), and environmental turbulence negatively related (beta=-.19, $p<.05$), to growth.

When independent decision-making variables are entered separately in Tests 2 to 4, the results are similar: decision quality and family's decision commitment are significantly related to growth but management's decision commitment is not. In a step-wise analysis, Tests 5 and 1 suggest that decision quality partially mediates the relationship between family's decision commitment and growth. The mediation is not full, because family's decision commitment is still marginally significant in Test 1.

Multicollinearity is not a problem in regressions testing the relationships between decision-making quality and firm performance. This can be seen in low variance inflation factors VIF in Tables 6.25 and 6.26. The adjusted multiple coefficient of determination

R^2 are at relatively low levels in Tables 6.26 and 6.27. This suggests that profitability and growth are greatly affected by other variables, which are not included in the model. F-ratios are at significant levels indicating that the models are adequate as a whole.

Table 6.27 Decision-making quality and growth

Variables	Growth						
	Test 1	Test 2	Test 3	Test 4	Test 5	Test 6	Test 7
Independent variables:							
Decision quality	.11†	.15*				.15*	.10†
Management's decision commitment	-.02		.09		.03	.01	
Family's decision commitment	.13†			.16*	.15*		.12†
Control variables:							
Generation	-.10	-.10	-.12	-.12	-.12	-.10	-.10
Firm size	.17*	.16*	.18*	.19*	.19*	.16*	.17*
Growth orientation	.09	.09	.09	.09	.09	.09	.09
Environmental turbulence	-.19*	-.18*	-.18*	-.19**	-.19*	-.18*	-.19*
Adjusted R^2	.07	.07	.06	.08	.07	.07	.08
F	3.18**	3.90**	2.23**	4.08**	3.41**	3.23**	3.72**
Max VIF	1.49	1.22	1.22	1.21	1.22	1.40	1.23

Missing values replaced with means; one-tailed tests for standardized beta weights in hypotheses, otherwise two-tailed tests; † p < .1, * p <.05, ** p < .01, *** p <.001

6.6 Summary of results

This chapter has empirically studied the hypothesized relationships among the constructs. Also, descriptive statistics of the sample firms addressing several key areas related to family firm governance were presented. Correlation and regression analyses were carried out in four blocks: Hypotheses 1 to 9 for the contractual governance model, Hypotheses 10 to 21 for relational governance model, Hypothesis 22 for joint effects of contractual and relational governance mechanisms, and Hypotheses 23 to 25 for decision-making quality and firm performance. Table 6.28 summarizes the hypotheses and empirical results. Overall, the hypotheses were well supported in the empirical tests.

Table 6.28 Summary of results

Description of hypothesis		Result
1	Family's inside ownership is negatively associated with proportion of outside directors on the board.	Supported
2	Proportion of outside directors on the board is positively associated with board monitoring of top management	Supported
3	Proportion of outside directors on the board is positively associated with board counsel to top management	Marginally supported
4	Board monitoring is positively associated with strategic decision quality	Supported
5	Board monitoring is positively associated with management's decision commitment	Not supported
6	Board counsel is positively associated with strategic decision quality	Supported
7	Board counsel is positively associated with management's decision commitment	Supported
8	Board composition mediates effects of inside ownership on board monitoring and board counsel	Partially supported
9	Board monitoring and board counsel mediate effects of board composition on decision quality and management's decision commitment	Not supported
10	Variety of family of institutions is positively associated with social interaction	Supported
11	Owner family size is negatively associated with social interaction	Marginally supported
12	Social interaction is positively associated with shared vision	Supported
13	Social interaction is positively associated with trust	Supported
14	Shared vision is positively associated with strategic decision quality	Supported
15	Shared vision is positively associated with management's decision commitment	Supported
16	Shared vision is positively associated with family's decision commitment	Supported
17	Trust is positively associated with strategic decision quality	Supported
18	Trust is positively associated with management's decision commitment	Supported
19	Trust is positively associated with family's decision commitment	Not supported
20	Social interaction mediates effects of variety of family institutions and family size on shared vision and trust	Partially supported
21	Shared vision and trust mediate effects of social interaction on strategic decision quality, management's decision commitment, and family's decision commitment	Partially supported
22	Contractual and relational governance have complementary effect on decision-making quality	Supported
23 a & b	Strategic decision quality is positively associated with profitability and growth	Partially supported
24 a & b	Management's decision commitment is positively associated with profitability and growth	Not supported
25 a & b	Family's decision commitment is positively associated with profitability and growth	Marginally supported

7 CONCLUDING DISCUSSIONS

Mounting evidence highlights the distinctive challenge of family firm governance. The unique characteristics of family businesses induce these businesses to maintain governance structures that combine elements of formal control for overseeing managerial decision making, and informal control for creating resources rooted in social relationships among the owner family members and management. Despite the wide recognition of the existence of this dual system of governance in family firms, empirical documentation of its effects on a firm's strategic decision-making process has been lacking. Therefore, this dissertation has sought to fill this gap in the literature by examining the systems of the contractual and relational governance, and their effects on family firms' strategic decision-making quality. Using a sample of family-controlled firms in Finland, the results support the importance of the dual systems of contractual and relational governance in explaining the quality of a company's strategic decision process. This concluding section of the dissertation reviews the study's key results, and discusses their implications for theory and practice. Further, it discusses the study's limitations and presents suggestions for future research.

7.1 Discussion of results

7.1.1 Contractual governance model

Contractual governance, which is formal and contractual in nature, is grounded in the family's ownership holdings. As extant literature has shown, family firms have specific contractual features that affect the relationship between the owners and management. First, the ownership is concentrated in the hands of a given family, and possibly with a few owner groups outside of the family. Concentration of the ownership allows the owner family members to participate in company decision making as directors or officers. So the separation of ownership and managerial control is significantly less in family firms than in widely held corporations. Second, family firms are relatively free from pressures of external governance mechanisms, such as the market for corporate control. On the one hand, this allows the family firm to concentrate on company development with "extended horizons" (Harvey, 1999b). On the other hand, lack of external control contributes to management's entrenchment, and so may allow poorly performing management to continue for a long time (Gomez-Mejia et al., 2001). Third, ownership holdings are mostly illiquid, prompting the family members to active, or "voice-based," ownership control (Nooteboom, 1999). These features focus attention on internal control in family firms.

Drawing on agency theory, the contractual governance model posited that the family firm's board of directors serves as the primary instrument through which the owner family monitors management's activities and supports its strategic decision-making processes. Literature on family business governance has demonstrated that family managers may be reluctant to involve outside members in the family firm's board, fearing that they may loose control if outsiders are involved (e.g., Schwartz & Barnes, 1991). Indeed, a high degree of variation in the roles and influence of boards of directors has been observed in family firms, ranging from no involvement to very active participation in governance (Neubauer & Lank, 1998). However, it has been widely recognized that outside presentation on the board is an opportunity for family firms (e.g., Johannisson & Huse, 2000; Ward, 1991). The main argument of the contractual governance model is that it is the ownership structure that largely determines the composition and functioning of boards of directors in family firms.

The results provided good overall support for the hypothesized relationships in the contractual governance model. First, the results showed that the proportion of equity owned by those family members, who were either directors or officers of the family firm, was negatively associated with the proportion of outside members on the board of directors. Second, increased outside presentation in the board resulted in more active board participation in terms of the board's control (monitoring) and service (counsel) functions. Third, the analysis showed that the intensity of the board's monitoring and counsel activities was positively associated with the quality of strategic decisions reached. Fourth, results indicated a strong statistical association between the board's counsel function and management's commitment to strategic decisions. However, the empirical analysis failed to support the hypothesis that board monitoring and management's decision commitment should be positively associated.

The first result showed that the owner family's inside ownership will influence the composition of its board of directors: the more the ownership and management coincide, the smaller the proportion of outside board members is likely to be. This may place the owner-managed firm at a disadvantage, because the theory suggests that board composition may have an important influence on its control and service functions. The result is consistent with agency theory, which proposed that the separation of ownership from decision control functions (initiation and implementation) leads to reduced overlap between the board of directors and top management by separating decision control (ratification and monitoring) from decision management (Fama & Jensen, 1983b). Further, similar empirical results were reported by Johannisson & Huse (2000), who found that "entrepreneurial" family businesses employed fewer outside directors than "managerial" family businesses.

Consistent with the received theory, the results demonstrated that the proportion of outside members on the board of directors would be positively associated with both its control and service functions. The data showed a particularly strong association between the presence of outside members on the board of directors and the intensity with which the board monitors management's actions. This result is in line with corporate governance literature; for example, Monks & Minow noted, "the board's primary role is to monitor management on behalf of the shareholders" (1996: 167).

However, the association between the board composition and board counsel was only marginally significant ($p<.1$). This result suggests that outside members' role in counsel and advice may be less prevalent than hypothesized. However, this significant positive association between the proportion of outside members and the extent of board counsel is similar to the empirical results of Huse (1993). He found that independent boards are positively related to service task of the board. Although the value of the role of outside members in advice and counsel is widely accepted in governance literature because, for example, outside members can provide new perspectives to strategic questions, (e.g., Zahra & Pearce, 1989), the inside board members usually have superior firm-specific knowledge (Fama & Jensen, 1983b). Further, inside directors other than the CEO may provide an important internal monitoring function, reducing the information asymmetries between the CEO and external board members (Johnson et al., 1996). Thus, both external and internal board members may contribute to counsel and advice in strategic decision making: outside members would provide more diversity in perspectives and information, while inside members would reduce information asymmetries and provide firm-specific knowledge. This may explain the weak positive association between the proportion of outside members and board counsel.

Supporting the fourth hypothesis, the boards' monitoring activities were positively associated with the quality of the strategic decisions reached. Agency theory posits that control activities help to better align the management interests with those of the owners. Further monitoring reduces information asymmetries between the management and board members, further improving the strategic decision quality. Prior research has demonstrated that the board can effectively control decision processes, even though strategic issues involve many uncertainties and ambiguities. This view is in line with Leifer & Mills (1996), and others, who have suggested that formal control may come in two forms. First, if cause-effect relationships can be established between a set of strategic choices and firm outcomes, then formal control of the strategic decision processes can be effective. Second, if the causal links cannot be determined, then output controls, measuring the expected results of strategic choices, are more applicable. Because there is a lot of causal ambiguity in strategic decision making, the literature has suggested that monitoring by the board is more effective when it addresses both process controls and output controls (Hitt et al., 1996). Process controls are more subjective in nature than output controls, but they contribute to identifying proper strategic criteria, and ensure that the decision process itself sufficiently covers the identification, development, and selection phases (Mintzberg et al., 1976).

Against expectations, the analysis demonstrated only a weak, statistically non-significant positive relationship between the management's decision commitment and the board's monitoring activities. The arguments for a positive relationship were largely based on "signaling effects" of board monitoring; monitoring by the board was expected to signal the board's own commitment to the strategic choices, and so to influence management's commitment. At least two reasons for the non-significant positive relationship can be presented. First, top managers of family firms are often family members and shareholders. Thus family-managers' interests may be naturally aligned through an ownership stake in the company, and the board's monitoring would not induce any further commitment to strategic decisions. Further, prior research has not clearly shown what the joint effects of monitoring and incentive alignment on managerial behavior are (Tosi et al., 1997). Because family-managers and non-family-managers are in different positions concerning incentive alignment, monitoring may have different effects on their decision commitment. Second, high levels of monitoring may be less effective, or as Gomez-Mejia et al. noted "marginal returns to monitoring are a decreasing function of the level of monitoring" (2001: 92). This implies that increasing monitoring improves decision commitment only to a certain point, after which it does not grow. Monitoring may even have a negative effect on managerial behavior. Ghoshal & Moran (1996) suggested "the use of rational controls adversely affects the feelings of both the controller and the controllee concerning their relationship" (1996: 24). Hierarchical control may create feelings of distrust among the parties, and lead to a "pathological spiraling relationship" (Ghoshal & Moran, 1996: 25).

The hypothesis that the board's counsel and advice would be positively associated with strategic decision quality was supported in the analysis. This result is consistent with an information-processing perspective of strategic decision making (e.g., Dooley & Fryxell, 1999; Leifer & Mills, 1996). This view holds that heterogeneity in decision-making teams promotes cognitive conflict and diversity in debate, thus improving the team's information processing capabilities. Higher quality decisions are reached, because a diversity of information better matches the information requirements of complex strategic issues.

Also, board counsel was positively linked to management's commitment to strategic choices, as hypothesized. The agency theory did not provide any direct arguments to support this hypothesis. Instead, justification of the hypothesis was mainly based on the procedural justice theory. It basically proposes that increasing involvement in decision processes will positively affect the participants' perceptions of the fairness of those processes, ultimately leading to better acceptance and commitment to the strategic choices reached (e.g., Kim & Mauborgne, 1998). Because the board counsel is based on directors' face-to-face contact with managers, it readily increases the engagement of both parties in the decision process, thus increasing their commitment.

The contractual governance model hypothesized several mediating effects, combined in two hypotheses. The results of the first mediating hypothesis supported the claim that effects of inside ownership are mediated, although not fully, through board composition on board monitoring, but failed to support the idea that effects of inside ownership are mediated through board composition on board counsel. The supported part of the hypothesis is consistent with the agency theory. As Fama & Jensen (1983b) proposed, the separation of ownership from decision management, as manifested in low inside ownership, leads to decision systems that separate management from control, as manifested in outside representation on the board of directors with higher levels of monitoring. The part of the results that refutes this suggests that there is no direct or indirect link (through board composition) between inside ownership and board counsel.

The results that refute the second mediating hypothesis indicate that neither board monitoring nor board counsel mediates the effects of board composition on decision-making quality (decision quality and decision commitment). Rather, the regressions indicated that board composition, when entered with board monitoring and board counsel, has a direct negative effect on both decision quality (only marginally so) and management's decision commitment. This result suggests that the interaction between board-related variables is more complex than hypothesized.

Several significant control variable effects were observed. Consistent with the expectations of the model, a higher generation in charge was positively related with a higher ratio of outside members on the board, whereas family's voting control and the incidence of dual leadership were negatively associated with the outside representation. As higher generation is generally related to larger ownership dispersion and decreased family members' participation in the firm's activities, a more outside-member oriented board can be expected. Both the voting control of the dominant shareholder group and dual leadership, i.e. the same person holding both the chairman and CEO officer positions, have been associated with higher levels of entrenchment in corporate governance literature. Thus, it can be expected that these structural factors are associated negatively with the outside influence on the board. Further, the results show that the firm size was positively associated with board monitoring and counsel functions, which is in line with the received theory. Finally, dual leadership was positively associated with management's decision commitment. This can be expected because dual leadership is usually associated with CEO's power and entrenchment.

7.1.2 Relational governance model

Corporate governance has traditionally been grounded in agency theory, which emphasizes the contractual nature of exchanges while ignoring the effects of ongoing social relationships (Granovetter, 1985). However, it is largely the nature of the kinship ties among the owners and managers that defines the unique characteristics of a family business. Therefore, it has been proposed in this dissertation that a relational view of governance is relevant in family firms because it considers the social capital embedded in the social relationships. While the contractual governance model focused on formal control exercised by the board of directors, the relational governance model addressed different forms of social capital, and their effects on firm performance. The relational governance model argued that communication and frequent exchanges among members of the owner family enable a shared vision and trust to form, influencing the quality of the strategic decision process.

The results showed good support for hypotheses on relational governance and on strategic decision making. First, social interaction among the owner family was positively associated with the number of different family institutions in use, and negatively with the family size. Second, the strength of a shared vision among family members and trust between the family and management were both positively associated with social interaction. Third, the shared vision was positively related with all three decision-making quality variables; trust was positively related to decision quality and management's decisions commitment, but failed to demonstrate a significant association with the family's decision commitment.

The extant literature suggests that when the third-generation of a family controls the business, the relationships among the extended family members become usually less intense and more politically oriented than those among the first and second-generation family companies (Gersick et al., 1997). In line with this suggestion, the results showed that the family size was negatively related to social interaction, although only marginally ($p<.1$). However, declining social interaction, weakening familial bonds and family members' reduced identification with the company can be overcome by implementing various processes and systems such family councils (e.g., Neubauer & Lank, 1998). Indeed, the results clearly showed that a more diverse use of family institutions was associated with higher levels of social interaction.

A shared vision among the key owners may play a key role within family firms because owner family members' equity holdings are typically long-term in nature. Making a conscious investment in the family's cohesion and shared vision may help the business by preventing dysfunctional behavior within the family, and by aligning the family's resources with those of the business. The results indicate that interactions among family members also emerge as a critical enabling process in the formation of a shared vision of the family firm's mission and goals. This is consistent with Harvey's (1996b) claim that traditions, bonding relationships, and loyalty inherent within families will help assume a long-term perspective of the family business. Further, the results are in agreement with Gulati (1995), who suggested that trust among the key stakeholders contributing to collective action forms incrementally over time with repeated interactions.

A shared vision was found a strong determinant of decision-making quality in the empirical test. First, the results demonstrated that the shared vision provides a common cognitive framework for decision processes leading to higher quality strategic choices. Supporting this finding, Nutt (1998) suggested that stakeholders' "claims," such as vision, frame decision making by activating the process and helping to select a direction to be followed. Second, the results demonstrate that a shared vision influences the commitment to strategic choices. The shared vision was statistically significantly related to both family's and management's decision commitment. The relationship was especially strong in the case of the family (beta=.59, $p<.001$). These results can be expected, because, in addition to a shared vision directing the decision-making process, it also improves the acceptance of decisions reached, and induces the cooperation needed in their successful implementation (Korsgaard et al., 1995; Nahapiet & Ghoshal, 1998).

Trust between the owner family and management was found significantly associated with the decision quality. Strategic decision quality-improving effects of trust can partly be accounted for by improved information processing, because trust gives the key stakeholders the confidence to be open in information exchanges, which in turn increases the amount of relevant and timely information needed to reach high quality decisions (Dooley & Fryxell, 1999; Zaheer et al., 1998). On the contrary, increased politics associated with low trust between the family and management is likely to impede the flow of information, and destroy cooperation, leading to sub-optimal decision making undermining shareholders' value (Cosier & Harvey, 1998; Eisenhardt & Bourgeois, 1988; Kets De Vries 1996).

As hypothesized, a high level of trust was associated with management's decision commitment. Like a shared vision, trust can greatly improve cooperation within decision-making groups (Mayer et al., 1995). Trust can provide organizational members a rationale to be "good agents," reducing individual opportunistic behavior, and justifying individual commitment to collective action such as implementing strategic choices (Leana & Van Buren, 1999). Trust as a source of commitment to collective action may have an added importance in family firms due to the long-term nature of exchange relationships.

Interestingly, a high level of trust failed to be significantly related to the family's decision commitment. Instead, the results showed a weak negative, non-significant association (beta=-.05, p>.1). This non-significant result occurred concurrently with the shared vision's strong association with the family's decision commitment as reported above. To gain more insight into how trust and the family's decision commitment may be related, a regression was run having just trust and control variables as independent variables, omitting the effects of the shared vision. This regression showed a significant, positive relationship between trust and the family's decision commitment (beta=.17, p<.01). This result suggests that trust may influence family members' commitment in strategic choices indirectly, having the owner family's shared vision as a mediating factor.

In addition to direct effects hypotheses, the relational governance model implied several mediating effects, as presented in Hypotheses 21 and 22. The results partially support the first one: social interaction mediates the effects of the variety of family institutions and family size on the shared vision, but fails to mediate them on trust. This result supports the proposition that social interaction is an enabling process for a shared vision to form (Kogut & Zander, 1996; Nahapiet & Ghoshal, 1998; Tsai & Ghoshal, 1998; Vroom & Yetton, 1973).

The other mediating hypothesis proposed that the effects of social interaction are mediated through a shared vision and trust on the three decision-making quality variables. The first part of the analysis showed that a shared vision and trust together fully mediate the effects of social interaction on strategic decision quality, as expected[1]. The second part indicated that a shared vision and trust together partially mediate the effects of social interaction on strategic decision. Finally, the third part failed to show any statistically significant mediation of social interaction through a shared vision and trust on the family's decision commitment. Instead, the results suggest that the family's decision commitment is directly influenced by both social interaction and shared vision, while not being affected by trust at all.

In sum, the relational governance model is supported well by the empirical tests. All the failing tests were associated with trust. Tests involving trust were supported in two cases and failed three cases. One reason for the poor performance of trust may be related to the way it was defined and operationalized. All the social capital constructs, except trust, addressed social capital within the owner family, whereas trust was defined and modeled as trust between the owner family and management. As long as the family also constitutes the management, this difference in definition does not matter. But when the degree to which the family and management differs, a potential error in results may occur. The reason that all the social capital constructs except trust explicitly addressed only the family, but not the management, was the study's objective of gaining an understanding of the effect of the family on the performance of the firm.

Several significant control variable effects were observed in the relational governance model. As the data show, the generation in charge of the family business is negatively associated with social interaction among the family members, which is consistent with the received literature. Also, generation in charge was positively related (marginally, $p<.1$) to both trust and family's decision commitment. These results suggest that affective responses, such as trust and commitment to decisions, increase as the family firm passes to following generations. This may reflect a proposal that family firm govern-

[1] Separate regressions, Tests 1b and 1d in Table 6.20, suggest that shared vision plays a bigger role than trust in mediating social interaction on decision quality.

ance becomes more sophisticated and explicit after generational transfers (e.g., Lansberg, 1999).

Inside ownership was positively related (only marginally, $p < .1$) to social interaction. This result implies that when the family members have multiple roles in the business, as directors and managers, it increases social capital within the family, social interaction directly, and shared vision and trust indirectly. This is in agreement with social capital literature that suggests that when the same people are linked together via multiple overlapping roles, their social ties are strengthened (Boissevain, 1974; Portes, 1998). Interestingly, inside ownership was negatively associated with decision quality, suggesting that the more the firm employs family members, the poorer is the quality of strategic decisions. Literature on nepotism is in line with this result (e.g., Kets de Vries, 1996).

Firm size was found negatively associated (only marginally, $p<.1$) with both trust and decision quality. The first result is quite obvious, because a larger firm employs a larger number of managers, making it less likely that they will form social relations, and trust, with the owner family members. Negative association between the firm size and strategic decision quality may reflect increasing agency costs due to the growing separation of ownership and management (e.g., Fama & Jensen, 1983b). Shared vision was linked to past financial performance and the number of family members on the board (only marginally, $p<.1$), as can be expected. Additionally, family members' participation on the board was positively related to the family's decision commitment (only marginally, $p<.1$). This result is obvious, because direct participation in decision processes is likely to increase the participants' acceptance of the choices (e.g., Kim & Mauborgne, 1998). Finally, the incidence of dual leadership was positively linked to management's decision commitment. This can be expected because in the case of dual leadership, the CEO has a good control of decision processes.

7.1.3 Joint effects of contractual and relational governance mechanisms

The contractual and relational governance models studied the effects of governance mechanisms on the decision-making quality as separate models. Hypothesis 22 proposed that, rather than being substitutive modes of governance, contractual and relational governance mechanisms, including board monitoring, board counsel, shared vision, and trust, have a complementary effect on the decision-making quality variables, including decision quality and management's decision commitment. The results indicated that the joint effects model explains the data significantly better than either the contractual or relational governance models alone, suggesting that the relational and contractual modes of governance indeed complement each other in family firm governance.

Although arguments for both complementary and supplementary relationships between formal control and informal, social control have been proposed in governance literature (e.g., Das & Teng, 1998), family business literature generally argues that both contractual and relational modes can add value to a family firm's governance, regardless of the size of the family or the business (e.g., Corbetta & Montemerlo, 1999; Gersick et al., 1997; Lansberg, 1999; Neubauer & Lank, 1998; Ward, 1987). Also, the evidence suggests that relational forms of governance may be more prevalent in small and young family firms, while older and larger family corporations rely increasingly on more contractual forms of governance, mainly by the board of directors with substantial outside member representation. This view is also supported by Huse (1993), who applied Macneil's (1980) "relational norms" to study relations between board of directors and management. Relational norms in contracting relations address relationship characteristics such as harmonizing role conflicts and preservation of the relation. Relational norms seem closely related to social capital because they also represent resources embedded in relationships. Huse found that the "theory of contractual relations" was supported for the smallest firms in his sample, but not for the largest firms. He concluded that "[r]elational norms and trust seem to be of greater importance in understanding and monitoring small firms than large firms" (1993: 235).

The normative recommendations have focused, roughly speaking, on two areas. First, a large number of researchers have recommended that family firms should more often use expert boards with outside members than currently is the case, especially in smaller firms (e.g., Brunninge & Nordqvist, 2001; Corbetta & Tomaselli, 1996; Schwartz & Barnes, 1991; Ward, 1991). Second, researchers have recommended the increased use of various structures within the family, or family institutions, for better governing the interaction between the family and the business (e.g., Gersick et al., 1997; Lansberg, 1999; Neubauer & Lank, 1998; Ward, 1987). These recommendations are mostly targeted at larger, extended families, where the familial bonds are weaker, and the owner family members' participation in the business is less.

7.1.4 Decision-making quality and firm performance

In the final set of three hypotheses, it was proposed that decision-making quality is positively related to a family firm's overall performance, as measured by profitability and growth of the firm. The results indicated that decision quality was significantly related to profitability and marginally significantly related to growth ($p<.1$), supporting Hypothesis 23. Tests failed to support Hypothesis 24: management's decision commitment was not significantly associated with profitability or growth. Hypothesis 25 received partial support, because the results showed that the family's decision commitment was positively associated with the family firm's growth (marginal support, $p<.1$), but did not show a significant relationship with profitability. In sum, these results partially supported the argument that strategic decision-making outcomes, in terms of decision quality and commitment of the key stakeholders, are positively related to the overall performance of the family firm.

To gain more insight into how decision commitment may be related to firm performance, additional analyses were performed to check the possibility of indirect effects between decision commitment and overall performance. The analyses suggested that decision quality mediates the effects of the management's decision commitment on profitability, and partially mediates the effects of the family's decision commitment on growth. The mediation results suggest that stakeholders' commitment can improve the overall firm performance only when the quality of strategic decision is at a high level.

As discussed in the theory development section, it has been found difficult to demonstrate a positive link between the strategy process and firm performance (e.g., Dean & Sharfman, 1996; Pearce et al., 1987). Although the performance measures were based on subjective assessments, the results of this study gave some support to the proposal that decision quality and decision commitment indeed contribute to firm performance.

For achieving the intended results of decision processes, previous research has highlighted the importance of reaching both high quality decisions and gaining commitment to their implementation (e.g., Amason, 1996; Dooley & Fryxell, 1999; Korsgaard et al., 1995). Further, the manner in which strategic decision processes are conducted can affect both the quality of decisions, and the commitment of participants to execute the decisions successfully.

As reported earlier, the results indicated that (1) decision quality was positively related to board monitoring, board counsel, shared vision, and trust, (2) management's decision commitment was related to board counsel, shared vision, and trust, and (3) family's decision commitment was related to shared vision. In order to reach both decision quality and decision commitment, these results may give some hints about critical governance issues. First, while board monitoring was related to decision quality, it was not related to the management's decision commitment. It can be speculated that in order to preserve the positive effects of board monitoring, and to increase the effects of this on management's decision commitment, it may be advisable to focus more on the strategic control aspect of board monitoring. This may be challenging to achieve with a high number of outside members, because boards with a high proportion of outside members may excessively employ financial controls at the expense of strategic controls (Hitt et al., 1996). Second, the total effect of trust is somewhat unclear: while trust was positively related to decision quality and management's decision commitment, it was weakly (non-significantly) related to family's decision commitment.

Finally, there were some significant effects in the regression for decision-making quality and the overall firm performance. First, environmental turbulence was negatively associated with profitability (only marginally, $p<.1$) and with growth. This result is in agreement with the extant literature (e.g., Eisenhardt, 1989b). Second, firm growth was positively associated with firm size. This may appear counterintuitive, because one might expect that small firms grow faster. However, the result is consistent with a firm's growth following an "s-curve," which is normally the case.

7.2 Theoretical and empirical contributions of the dissertation

Family firms are generally considered as an understudied enterprise context in managerial studies; consequently family businesses have largely remained omitted from rigorous conceptual and empirical studies (Litz, 1997). Researchers have neglected family firms because there has been a widespread belief that corporations will become more diffusely-owned by institutional owners and managed by professional management instead of being owned and controlled by families (Lansberg et al., 1988). However, it is nowadays recognized that family firms have a large macroeconomic impact, and they will remain as a viable enterprise form in the future. Although family business research is young as a field of inquiry, it is gaining increasing interest among a diverse group of researchers (Brockhaus, 1994). This dissertation contributes to the growing stream of research on family business by developing and testing hypotheses on family firm governance, an area where the research has been "particularly scarce" (Neubauer & Lank, 1998: xv).

The role of the family in family businesses has engendered much discussion in the literature. Earlier literature considered the family potentially harmful to business, thus it was recommended to keep the family out of the business (e.g., Levinson, 1971), while more recent literature considers the family as a potential source of competitive advantage (e.g., Davis & Herrera, 1998). This study has demonstrated how the family can affect the business via multiple roles and mechanisms. This study has argued that family firm governance should be grounded on the unique characteristics of family firms, which, are to a large extent, the result of interactions of the family, ownership, and management (Gersick et al., 1997; Tagiuri & Davis, 1982).

The unique characteristics imply that a family business has potentially many cohesive forces such as kinship ties, relatively illiquid ownership stakes, and the family members' high involvement through various roles, that keep the family business succeeding over long time horizons. However, the same factors can lead to less satisfactory developments if the governance of family business system fails. Thus, this study has aimed at developing a better understanding of family firm governance by addressing both the formal aspects of governance that regulate the relationship between the owners and the management, and the social aspects of governance that are deemed important to constructive interaction between the family and the company. To do this, the dissertation has expanded the use of agency theory in corporate governance by incorporating elements from social capital theory. Therefore, the dissertation offers a more comprehensive analysis of family firm governance.

The agency theory and family business research has a somewhat ambivalent relationship. Some family business studies have applied the agency theory as a theoretical framework (e.g., Daily & Dollinger, 1992; Gomez-Mejia et al., 2001; Hufft, 1997; McConaughy, 1994), while some others have questioned its applicability in a family business context (e.g., Dyer, 1994; Schulze et al., 2001). Although the family business context may challenge some of the assumptions of the agency theory, the present study has argued that the agency theory is applicable to the study of family firm governance. This claim was justified by the fact that separation of ownership from control also occurs in family firms, although to a smaller extent than in diffusely-owned, large corporations. Thus, this study contributes to the empirical testing of the agency theory. The contractual governance model presented in this study follows the overall argument of the agency theory, which suggests that a firm's ownership structure, defined in terms of outside equity (equity not owned by top management), determines to a large extent the governance systems used in the firm, and that, in turn, affects how economic value is created in the firm, and distributed among the stakeholders (e.g., Jensen & Meckling, 1976). This study focuses on family firms' internal governance systems, addressing the composition and functions of the boards of directors, and their effects on the firm's performance.

Corporate governance literature has identified two broad tasks of the board of directors: the control task and the service task. The present study used these categories to define and operationalize the functions of the board employed in the contractual governance model. The results of the study were in agreement with received governance literature, because the empirical analyses identified the board monitoring (control) and the board counsel (service) as distinctive factors.

The social capital theory appears highly applicable to the study of family firms because of the strong social ties and enduring exchanges among the key stakeholders in those firms. Surprisingly, past family business research has not explicitly used the social capital theory as a theoretical framework. This dissertation clearly shows that the notion of social capital is highly applicable in family business research. Social capital research distinguishes between weak and strong social ties. Research on weak ties typically focuses on entrepreneurial opportunities through unobvious social ties, whereas research on strong ties addresses the cohesiveness of a group, and voluntary cooperation within that group. The present study contributes to the research on strong ties.

The relational governance model addressed three dimensions of social capital that have been identified in the extant literature, including the structural, relational, and cognitive dimensions. By using these dimensions, altogether five social capital constructs were defined and operationalized. In line with the received theory, three multi-item social capital measures were distinguished as separate factors. These results contribute to the empirical validation of social capital constructs, and support the proposal that social capital is a multi-dimensional concept.

While formal governance, which focuses to a large extent on the boards of directors, has received extensive attention in past research, the relational governance has only recently been brought under systematic empirical study. Consequently, the relevant social capital constructs are not well understood, neither is the way they are related in relational governance systems. The present study contributes to this understanding by proposing and testing relationships among the social capital constructs in a family firm governance context. Social interaction among the owner family members was found as a key mechanism that enables various family institutions to generate other forms of social capital, such as a shared vision. Although the extant literature has recognized the importance of family institutions in the development of "enlightened" family ownership (e.g., Lansberg, 1999), the knowledge of social mechanisms explaining how this actually happens has not been very clear. The present study has shed some light onto this question.

Furthermore, the findings of this dissertation concerning the dual system of contractual and relational governance may be applicable to corporate governance contexts other than that of the family business. In many cases, there are enduring interactions between the owners and management of a firm. This might be the case, for example, when the investor takes a large ownership position and holds it for long period of time, and actively monitors the investment. As mentioned earlier, Brancato (1997) termed this type of investor a "relationship investor." She identified Warren Buffet of Berkshire Hathaway Inc. as a "guru" of relationship investing. Also, venture capital companies, which typically provide long-term equity financing and other services to growth companies, are likely to employ elements of both contractual and relational governance. Further, other types of institutional investors may possess similar characteristics of active governance, including, for example, various pension funds. Finally, many private and corporate investors may hold significant blocks of equity of corporations, and consequently be actively involved in governance of those. Indeed, there is a trend for growing investor activisms aiming at improving corporate performance for a select group of owners (Brancato, 1997; Monks & Minow, 1996). The present dissertation is consistent with this growing trend because it contributes to the understanding of how companies with enduring interactions between owners and management are governed, including both contractual and relational governance mechanisms.

Corporate governance literature has addressed links between governance and performance of firms in different ways. A number of studies have focused on how ownership and governance influence a firm's financial performance (e.g., Agrawal & Knoeber; 1996; Morck et al., 1988; Oswald & Jahera, 1991). However, these studies do not explain the processes and mechanisms by which the overall performance is reached. Some other studies have addressed how governance has influence on some internal measure of performance, such as firm innovation (Hitt et al., 1996), or restructuring (Johnson et al., 1993). A growing number of studies have specifically addressed the links between corporate governance and strategic decision processes (e.g., Baysinger & Hoskisson, 1990; Daily & Dalton, 1993; Judge & Zeithaml, 1992; Tashakori & Boulton, 1985; Zahra, 1990). This dissertation contributes to this stream of research by addressing how governance mechanisms, both contractual and relational, affect the strategic decision processes in terms of the quality of the decisions reached, and the stakeholders' commitment to successfully implement those decisions.

The present study has participated in research addressing the relationship between strategic decision-making processes and the firm's overall performance. As discussed earlier, it has been difficult in past research to demonstrate a positive association between a firm's strategic process and its financial performance due to many contingencies and effects influencing the performance (e.g., Pearce et al., 1987). The results of this study gave some support to the proposition that strategic decision-making quality variables are related to a firm's profitability and growth. Further, this dissertation has contributed to the study of strategic decision-making processes in family firms, an area that has not been researched much (e.g., Harris et al., 1994; Sharma et al., 1997).

Finally, the dissertation broadens the base of data that have been used in corporate governance research. Past research in corporate governance has mostly studied large companies such as Fortune 500 corporations (e.g., Dalton et al., 1999). The data set used in this study contributes to empirical research on family firms, which represent almost entirely small and medium-sized companies.

7.3 Managerial implications

This study has demonstrated the extensive and distinctive challenge of family firm governance. Governance of a family business is a multi-faceted task where both the business and the owner family need to be addressed. The existence of a dual system of governance suggests that family firms can reduce agency problems related to eventual and gradual separation of ownership from control, and at the same time, maintain a continuingly cohesive family needed as a value-adding owner group for the business.

It appears that family firm success has many threats. On the one hand, when managed and governed well, a family firm can create wealth and success to its stakeholders over a long time, sometimes over many succeeding owner family generations. On the other hand, a family firm has a considerable chance to cease as a family business, in more or less dramatic circumstances. Sometimes the decision to sell or discontinue the family firm can be a rational and jointly agreed event. However, family firms often discontinue because the business goes bankrupt or the family is forced to sell the company. Even when the company continues as a family firm, it may experience a prolonged period of low success, and just barely survive. It has been argued in this study that proper governance can make a difference to the success of a family business. In order for this to happen, family business leaders and owners need to be aware of the dual nature of family firm governance, and to develop governance systems accordingly.

Results of the contractual governance model indicate that selecting qualified outside directors can improve the strategic decision-making outcomes and firm performance significantly. The increased proportion of outside directors on a board enhances monitoring and, to a lesser extent, counsel offered to management. In turn, monitoring and counsel by directors improve strategic decision quality. Also, increased counsel from the board improves management's decision commitment.

However, family business owners tend to underutilize external information and assistance provided by expert boards. Owner managers, in their quest to retain their powers, may overlook the importance of outside directors' contributions to their firms' strategic decision making. As the results show, the proportion of outside members increases only when the inside ownership (equity held by those family members who are either directors or officers) decreases. In order to reap maximal benefits associated with outside board members, the owner managers should consider hiring these directors in the early phase of the company development, well before they "appear to be needed" by other owners. This is likely to accelerate the positive development of the business. Perhaps, the owner managers' goal of retaining control of the firm while using outside sources of information can be accomplished by carefully selecting independent outside directors, providing incentives to them, and integrating them into the family firm's culture.

The results indicated that board monitoring did not improve the management's decision commitment. This result is consistent with existing literature, which claims that excessive control of managers may become counterproductive, as mutual trust may decline. Also, outside directors may rely more on financial controls than on subjective strategic controls. Consequently, the directors should be aware of the possible effects of formal control on the managers' motivation, and seek a balance between financial and strategic controls.

The results also showed that family ownership matters a great deal, as indicated in the significant influence of the relational governance system on strategic decision-making quality. Other types of firms may not possess this advantage. Clearly, family business owners need to give attention to refining the more informal, relational governance system that strengthen familial ties and family cohesion. This can be achieved through promoting effective and frequent communication, sharing a vision of the company's future with the rest of the family, resolving disputes among family members, and behaving in ways that engender trust.

Social interaction was found to be a process central to promoting the formation of a shared vision and trust, which then improve decision quality and commitment. Owner families can induce more varied social interactions by implementing various family institutions. Smaller families may rely on informal and formal family meetings. When the family grows, family councils may be also taken into use. The role of the family council is to represent the whole owner family, and make preparations for family meetings. The process of writing a common ownership plan, or family plan, can be recommended to every family, regardless of its size. Although family institutions are beneficial to any family, extra care should be taken in larger, extended families, where the occasions for natural social interaction have diminished.

The results demonstrated that a shared vision among the owner family members was associated more strongly with decision quality and decision commitment than was the mutual trust between the family and management. It may be that achieving the shared vision requires conscious effort by the owner family members, while trust could be a "byproduct" of social interaction and previous trustworthy behavior.

Put simplistically, it can be argued that larger family firms have more development needs in relational governance, while smaller family firms are likely to lack contractual governance systems. However, in any kind of family business, the complementary benefits of contractual and relational governance need to be understood, and actions taken to improve the governance systems.

Systems of contractual and relational governance are not isolated from each other, but they are intertwined through family-related factors. First, social interactions among the owner family members are amplified when family members work in the company. This is likely to be the case in smaller family firms. On the contrary, in larger family firms this is not anymore the case. Second, when the company employs family members, they tend to be younger firms, which do not generally take advantage of outside board members. Consequently, these firms are more entrenched against outside influence. In sum, while high family participation as directors, managers, and employees is likely to increase social capital within the family, it may also increase the family's entrenchment in the company. Family business owners should be aware of these influences, and consider an optimal level of the family's participation in the business.

The present study has suggested that successful strategic decision making results in high quality decisions, and the key stakeholders' commitment to execute those decisions successfully. Reaching both of these objectives is challenging because the same conflict-laden processes that yield high quality decisions may hamper consensus and commitment. Thus, it is important that participants in decision processes promote debate and cognitive conflicts for achieving more varied information, while avoiding affective conflicts that destroy acceptance of, and commitment, to strategic choices.

7.4 Limitations of the study

The dissertation's encouraging results should be interpreted with caution in view of the study's potential limitations. The generalizability of the findings is limited by the sample, which is taken from Finland, and from a set of family firms representing the more established family business. Finland is often considered to be a more 'relational' country, as opposed, for example, to the more transaction-oriented culture in Anglo-Saxon countries. Thus, Finnish companies may have developed unique ownership and governance structures that mirror national culture. However, it is assumed that the general thrust of the findings should hold also in other cultural environments, because national cultures are likely not to exercise a significant influence on how different governance mechanisms function within a family firm.

The study is likely to have some limitations concerning the generalizability of the results, because the sample of the study consisted of family businesses that were five years or more years old, and were corporations. These limitations were set for making it possible to investigate the research problem of this dissertation. Consequently, other organizational forms such as proprietorships and partnerships were excluded from the sample. A corporate form of business was selected as a criterion because equity claims in corporations have a limited liability feature, allowing easy transfer of equity and growth of ownership base. Also, start-up companies were excluded because only corporations that were five years or more years old were accepted. Thus, “new, technology-based firms” (Autio, 1997) were poorly represented in the sample. Indeed, the sample consisted mainly of more “traditional” businesses, such as manufacturing, retailing, and transportation. However, the selection of sample firms does not present a serious limitation because the purpose of the study, in the first place, was to investigate family firms with certain characteristics. For example, the companies in the sample had a board of the directors, considerable variation in the degree to which ownership is separated from management control or in family size. Although the sample firms represented the more established industries, they were generally modern and competitive, and often had a strong international dimension to their business. Different industries were not controlled for in the analyses. Instead, as an approximation, industry effects were taken into account by controlling for environmental turbulence. In sum, it can be concluded that the results of the study can be generalized into a significant sub-population of family companies in Finland, both in terms of total production volume and broader economic impact.

The fact that the data are cross-sectional, collected at a particular point in time, is a potential limitation of the study. Although the research models imply several causal relations between the constructs, the cross-sectional research design does not allow testing causality directly. Thus, claims of causality are based on theoretical arguments. A more longitudinal approach is required to obtain better insight into influences such as those on company performance. This is an opportunity for future research.

Further, collecting data of the type used in this research is a time consuming process and companies are often reluctant to share information about their strategy making process. Also, as in several parts of the world, Finnish family-controlled companies do not share information about their diverse operations with the public. This has led to a lack of data in public sources about these firms. Therefore, the data were collected from senior executives and owners. The fact that data were collected primarily from one source should also be considered when interpreting the results. While the results of the validation interviews and tests for source bias were reassuring, it would have been ideal to collect data from multiple sources. These limitations notwithstanding, the results have several implications for effective managerial practice and future theory development.

7.5 Directions for further research

The findings of this dissertation point to several further research opportunities. First, in the area of contractual governance, greater attention should be given to understanding the contribution of outside directors to counseling senior managers. The results show that the proportion of outside directors on the board is positively, but only marginally, related to board counsel. This suggests that inside board members may also provide counsel and advice to management. Inside members, including owner family members and company managers, should have superior business and family specific knowledge. Future research should address whether there is an optimal ratio of outside members. This question is important because the board counsel variable is positively and significantly associated with decision quality and commitment.

Another area in contractual governance needing further exploration is the relationship between the board's monitoring activities and management's decision commitment. As the results showed, no relationship was detected between these two variables. Because the board monitoring is a manifestation of formal control in corporations, its influence on decision commitment is of great importance. Future research could address separately the effects of strategic and financial controls, and perhaps investigate possible moderating effects between monitoring and commitment. It can be speculated that at higher levels of trust, the monitoring may be related more strongly to decision commitment.

The results for relational governance suggest several areas for future research. The variety of family institutions was found to be an important factor for increasing social interactions, and other forms of social capital within the owner family. Researchers need to better understand and document these institutions. Prior research on family institutions has been descriptive, suggesting a need for a more detailed analysis. Further, this study has treated a shared vision as a one-dimensional construct. The shared vision may contain multiple dimensions, perhaps having different effects on decision-making quality variables. Thus, refining the shared vision construct, and testing its relationships with other governance and decision variables provide further research opportunities. Finally, the forms and roles of trust need to be elaborated in future research. This study examined the effects of trust between the owner family and management. However, trust can exist in any relationship among the family, board, and management.

This dissertation treated contractual and relational systems of governance as complementary approaches to governance. Empirical tests supported that proposal. However, it can be argued, for example, that trust substitutes for formal control, as trust is assumed to reduce opportunistic behavior. Also, the relative importance of contractual and relational modes of governance may depend on several factors such as family and company sizes. Further, relational and contractual governance may interact due to the fact that family members may have multiple roles in the family business. Finally, the efficacy of these two systems of governance in dynamic versus static environments deserves an examination. Clearly, researchers should explore the relationships of these two systems.

This dissertation explored the effect of contractual and relational governance on a company's financial performance by using the key respondents' subjective evaluations of company profitability and growth. This analysis could be extended to a longitudinal analysis, using more objective financial data. Also, studying the direct effects of contractual and relational governance variables on the firm's performance constitutes an obvious and important avenue for further research.

Finally, other outcome variables could be investigated. One such variable is entrepreneurial orientation, which is often considered as an important factor for a company's renewal and survival. Maintaining entrepreneurial orientation may present a challenge for family firms, because they may become stagnant over time as traditions and long-held values develop. The question of how a family firm's governance structures affect its entrepreneurial orientation and eventually, its growth is one possible direction for future research.

7.6 Conclusion

Family firms are an important and viable sector of the global economy. However, research on the effects of family ownership structure, and governance systems has been limited in past research. Using data from Finnish firms, this dissertation has examined the dual system of governance that exists in family-controlled companies. The results show that contractual and relational governance systems coexist, reflecting the unique characteristics of family firms. These two systems of governance complement each other, serving to improve the strategic decision quality of family firms and the commitment of family firms to these decisions, and so ultimately improving overall firm performance.

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Appendix A **Questionnaire** Mikko Mustakallio

Original questionnaire is in Finnish

Your answers will remain strictly confidential. Results will be presented in statistical aggregate only. No reference will be made to individual firms. Thank you, in advance, for helping me complete my dissertation research!

Section A Business Description

A1 Name of company: ________________________________

Your name: ________________________________

Your position: ________________________________

I belong to the owner family Yes ☐ No ☐

A2 Year company was founded _____ Family has controlled company since year _____

Generation currently in charge...

☐ 1. ☐ 2. ☐ 3. ☐ 4. ☐ 5. or later generation

If there are two generations in charge, which one is secondary?

☐ 1. ☐ 2. ☐ 3. ☐ 4. ☐ 5. or later generation

A3 Describe briefly the main business of your company. For example*: Development and manufacturing of machinery for wood-based panel industry* or *providing cleaning services to industrial companies*

Main business: ____

In how many industries does the company operate? The company operates in _____ industries

A4 I would like to learn about your business and the industry in which your company operates. Please circle on a scale from 1-7 the extent to which you agree with the following statements.

	DO NOT AGREE						COMPLETELY AGREE
Products/services become obsolete very slowly in your firm's principal industry	1	2	3	4	5	6	7
Your firm often needs to change its marketing practices to keep up with competitors	1	2	3	4	5	6	7
Demand and customer preferences are very easy to forecast in your firm's principal industry	1	2	3	4	5	6	7
Actions of competitors are unpredictable	1	2	3	4	5	6	7
Your firm must frequently change its operating procedures to keep up with competitors	1	2	3	4	5	6	7
Business is based on the application of a variety of different core competences	1	2	3	4	5	6	7
The production system of the company is highly sophisticated	1	2	3	4	5	6	7
Products of the company are technically complex	1	2	3	4	5	6	7
The company's services require the highest level of competence	1	2	3	4	5	6	7

A5 What percentage of revenue in 1999 came from customers outside Finland? _____ %

A6 Please allocate 100 points between the statements below to describe your company's growth strategy. For example, if your company is primarily trying to grow by increasing sales to present customers, you might mark 90-10 on the first line.

For increasing sales we focus on present customers	_____ - _____ (total 100 points)	*For increasing sales we focus on new customers*
For increasing sales we focus on present products	_____ - _____ (total 100 points)	*For increasing sales we focus on new products*

Section B Ownership structure, Board, and family members' participation in business

B1 How large is the owner family? ____persons (only shareholding family members)

B2 Does your company have two or more series of shares, each series having different voting rights?

- ☐ No, the company has only one series of shares
- ☐ The company has two series of shares, each with different voting rights
- ☐ The company has three or more series of shares, each with different voting rights

B3 How much is the family's total voting control of the company? Voting control can be calculated by dividing the number of votes attached to shares owned by the family by the number votes attached to total outstanding shares. The family's voting control is _____%

B4 Assess how the ownership is distributed among the following owner groups:

Family, directly or through holding companies:	______ % of shares
Non-family management:	______ % of shares
Outside small investors:	______ % of shares
Institutional investors (banks, venture capitalists, etc.):	______ % of shares
Other owners:	______ % of shares
TOTAL	100 %

B5 Ownership of those family members who act as directors and executives in the family firm is approximately ______ % of shares, representing approximately ______ % voting control

B6 The Board of Directors has a total of _____ members, consisting of

family members:	_____persons
independent members outside family and management:	_____persons
Non-family managers:	_____persons

Chairman of the Board is a family member: ☐ Yes ☐ No

Number of family members who are part of the Board and management is ____

Chairman of the Board and the CEO is the same person: ☐ Yes ☐ No

B7 The owner family members occupy the following positions:

CEO is a family member: ☐ Yes ☐ No

Management positions, total _____persons

Non-management positions, total _____persons

B8 When did the latest succession of the CEO take place?

- ☐ Has not yet taken place
- ☐ It took place in year _____
- ☐ From the year _____ the CEO has been outside the family

When did the latest succession of the Chairman of Board take place?

- ☐ Has not yet taken place
- ☐ It took place in year _____
- ☐ From the year _____ the Chairman has been outside the family

Section C Strategic decision making

C1 Family firms may pursue many different goals. Each company has their unique set of goals that they pursue. Some goals can be seen as means to achieve higher-level goals. Please use the 1-7 scale to evaluate the importance of the following goals to your company.

	Not at all an important goal			A rather important goal			A very important goal
To maximize sales growth	1	2	3	4	5	6	7
To maximize profitability	1	2	3	4	5	6	7
To maximize the firm's value	1	2	3	4	5	6	7
To continue the firm as a family business	1	2	3	4	5	6	7
To maximize return on equity	1	2	3	4	5	6	7
To achieve longevity for the company	1	2	3	4	5	6	7
To sell the company if an opportunity arises	1	2	3	4	5	6	7
To pay as high dividends as possible	1	2	3	4	5	6	7
To pay steady dividends	1	2	3	4	5	6	7
To be among the top three companies in the main business	1	2	3	4	5	6	7
To provide financial independence to family	1	2	3	4	5	6	7

C2 Please rank the following goals according to their importance to your company by allocating 100 points so that the amount of points given to a goal reflects its importance.

Increasing revenue rapidly:	________points
Profitability:	________points
Retaining the company in the hands of the family	________points
Secure the longevity of the company	________points
TOTAL	100 points

C3 Please circle on a scale from 1-7 the extent to which you agree with the following statements.

	DO NOT AGREE						COMPLETELY AGREE
Family members agree on the most important goals of the firm	1	2	3	4	5	6	7
Management team members agree on the most important goals of the firm	1	2	3	4	5	6	7
Family and management have discussed a lot of the most important goals of the firm	1	2	3	4	5	6	7

C4 Think about the three most important strategic decisions made in the near past (1-5 years) that contributed to achieving the most important goals in your firm. Such goals may be found in C1 above, but other goals can be considered too. Please circle on a scale from 1-7 the extent to which you agree with the following statements.

	DO NOT AGREE						COMPLETELY AGREE
Strategic decisions were based on the best available information	1	2	3	4	5	6	7
Strategic decisions were made on the basis of valid assumptions about the development of the business environment	1	2	3	4	5	6	7
Strategic decisions helped (help) the company achieve its objectives	1	2	3	4	5	6	7
Strategic decisions make sense in light of the company's current financial situation	1	2	3	4	5	6	7
Strategic decisions are consistent with the family firm's vision	1	2	3	4	5	6	7
Strategic decisions contribute to the overall effectiveness of the company	1	2	3	4	5	6	7
Family members support the strategic decisions	1	2	3	4	5	6	7
Top management did not support the alternatives that became the final decisions	1	2	3	4	5	6	7
Family members feel there is not much to be gained by sticking with the strategic decisions	1	2	3	4	5	6	7
Top management is willing to put in a great deal of effort to see the strategic decisions be successful	1	2	3	4	5	6	7
Family members are willing to talk strategic decisions up with other family members as being good for the company	1	2	3	4	5	6	7
The decisions were consistent with top management's priorities and interests	1	2	3	4	5	6	7
Family members really care about seeing the strategic decisions be successful	1	2	3	4	5	6	7
Top management have supported strategic decisions that were made	1	2	3	4	5	6	7
Multiple criteria were used in decision making for eliminating possible courses of action	1	2	3	4	5	6	7
The pros and cons of several possible courses of action were examined	1	2	3	4	5	6	7
The group weighted multiple approaches against each other in decision making	1	2	3	4	5	6	7
Bilateral communication existed between the family members and Board of Directors/top management involved in the family firm's strategic decision making	1	2	3	4	5	6	7
Family members could challenge and refute the strategic views of the Board of Directors/top management	1	2	3	4	5	6	7
Family members received a full account of the final strategic decisions of the Board of Directors/top management	1	2	3	4	5	6	7
The Board of Directors/top management involved in strategic decision making were well informed about the situation of the family	1	2	3	4	5	6	7

C5 Please circle on a scale from 1-7 the extent to which you agree with the following statements.

	DO NOT AGREE						COMPLETELY AGREE
Profitability of the business is based on higher prices of products and services compared to competition	1	2	3	4	5	6	7
Profitability of the business is based on lower costs compared to competition	1	2	3	4	5	6	7
Sales growth will primarily come outside from Finland	1	2	3	4	5	6	7
Expanding the business will be based on utilizing current core competencies	1	2	3	4	5	6	7
Expanding the firm will be based on developing completely new, unrelated businesses	1	2	3	4	5	6	7
Scarce financial resources sometimes prevent implementing profitable investment opportunities	1	2	3	4	5	6	7
Issuing shares outside the family is a possible way to obtain new equity capital	1	2	3	4	5	6	7
The financial structure of the firm is optimized between equity and long-term debt	1	2	3	4	5	6	7
Long-term debt is avoided in the firm	1	2	3	4	5	6	7
The firm has a very strong emphasis on research and development	1	2	3	4	5	6	7
The firm has introduced only a few new products or services in the past 5 years	1	2	3	4	5	6	7
The firm has a strong proclivity for high risk projects (with changes of very high returns)	1	2	3	4	5	6	7
Owing to the nature of the environment, it is best to explore it gradually via cautious, incremental behavior	1	2	3	4	5	6	7
The firm typically initiates actions to which competitors then respond	1	2	3	4	5	6	7
The firm is very seldom the first to introduce new products/services and operating technologies	1	2	3	4	5	6	7

C6 Who makes the <u>most important decisions</u> of the firm? Assess where the actual decision-making power lies among the key stakeholders. Please allocate 100 points between the following three alternatives. Allocate the points so that the party holding most actual decision power receives more points than the other altenatives.

CEO ________points
Board of Directors ________points
Owner family ________points
TOTAL ___100___points

Please circle on a scale from 1-7 the extent to which you agree with the following statements.

	DO NOT AGREE						COMPLETELY AGREE
CEO has a great deal of power	1	2	3	4	5	6	7
CEO does not participate much in making fundamental decisions pertaining to the firm	1	2	3	4	5	6	7
The Board of Directors makes all the fundamental decisions	1	2	3	4	5	6	7
The Board of Directors acts only as a formal decision-making body	1	2	3	4	5	6	7
The family can in practice influence the most important decisions pertaining to the firm	1	2	3	4	5	6	7
The family does not participate in decision making, not even in the most important cases	1	2	3	4	5	6	7

Section D Governance and compensation of management

D1 Please circle on a scale from 1-7 the extent to which you agree with the following statements.

	DO NOT AGREE						COMPLETELY AGREE
Formal financial reports prepared by top management are reviewed in board meetings	1	2	3	4	5	6	7
Return criteria such as return on assets, return on invested capital, and so forth are regularly followed-up in board meetings	1	2	3	4	5	6	7
Cash flows are regularly followed-up in board meetings	1	2	3	4	5	6	7
Return on investment of large individual investments are regularly monitored by the Board	1	2	3	4	5	6	7
The Board closely monitors top management's strategic decision making	1	2	3	4	5	6	7
The Board formally evaluates performance of top management in regularly held feed-back meetings	1	2	3	4	5	6	7
The Board usually defers to the CEO's judgment on final strategic decisions	1	2	3	4	5	6	7
The Board is actively involved in shaping the firm's strategy	1	2	3	4	5	6	7
The Board and top management often discuss the firm's future strategic choices	1	2	3	4	5	6	7
Board members give top management plenty of counsel on the firm's strategy	1	2	3	4	5	6	7
Top management very often solicit Board assistance in the formulation of corporate strategy	1	2	3	4	5	6	7
Outside directors (outside of family and management) function as useful "sounding boards" on strategic issues	1	2	3	4	5	6	7
Directors provide advice and counsel in discussions outside of board meetings	1	2	3	4	5	6	7

D2 How much is the compensation of management determined by the performance of the firm?

☐ There is no performance pay in use
☐ Performance pay can be 20% of total compensation
☐ Performance pay can be 20% - 40 % of total compensation
☐ Performance pay can be 40 % or more of total compensation

Does the management have an option incentive system that is based on the value of the firm? The value of the option can be determined from publicly listed shares, if applicable, or it can be based on a calculated value.

☐ Not in use ☐ Management has an option incentive system

D3 Please circle on a scale from 1-7 the extent to which you agree with the following statements.

	DO NOT AGREE						COMPLETELY AGREE
Decision rights have been delegated to lower levels of organization	1	2	3	4	5	6	7
Upper management often makes day-to-day routine decisions	1	2	3	4	5	6	7
Decisions are made at levels where there is the best knowledge about the issue	1	2	3	4	5	6	7
Decision rights of personnel are documented	1	2	3	4	5	6	7

Section E	Relationships within the family and between the family and firm

E1 Please circle on a scale from 1-7 the extent to which you agree with the following statements.

	DO NOT AGREE						COMPLETELY AGREE
Family members share the same vision about their firm	1	2	3	4	5	6	7
Owner family members seldom have disagreements concerning the "big picture"	1	2	3	4	5	6	7
Family members are committed to jointly agreed goals of the firm	1	2	3	4	5	6	7
Family members agree about the long-term development objectives of the firm	1	2	3	4	5	6	7
Owners can rely on top managers without any fear that they will take advantage of them, even if the opportunity arises	1	2	3	4	5	6	7
Owner family negotiates joint expectations fairly with the top management	1	2	3	4	5	6	7
Top management takes advantage of family's problems	1	2	3	4	5	6	7
Owner family tries to get the upper hand over top management	1	2	3	4	5	6	7
Top management tries to get out of its commitments	1	2	3	4	5	6	7
Top management regards the owner family as reliable	1	2	3	4	5	6	7
Top managers will always keep the promises they make to owners	1	2	3	4	5	6	7
Top management and owner family rely on each other	1	2	3	4	5	6	7
Family members maintain close social relations	1	2	3	4	5	6	7
Family members know each other on a personal level	1	2	3	4	5	6	7
Family members seldom visit each other	1	2	3	4	5	6	7

E2 Does the family at times informally come together to discuss family and business related matters?

☐ No
☐ Yes, _______ times per year

Does the family at times arrange more formal "family meetings", in which family and business related matters are discussed according to a certain agenda?

☐ No
☐ Yes, _______ times per year

Does the family have a "family council" or similar? The role of the family council is to represent the whole owner family, and make preparations for family meetings

☐ No ☐ Yes

Does the family have a written "ownership plan", or similar, which states, for example, ownership values and goals, principles concerning relationships between the family and firm, and principles concerning transfer of shares and dividend policy

☐ No ☐ Yes

Section F	Company size and performance

F1 Please indicate the approximate number of full-time employees and total sales of your company at the end of each year.

	1997	1998	1999	2000 (est.)
Total number of employees				
Total sales, million FIM				

F2 Please estimate how well the following goals have been reached in your company.

	Lagging badly behind the goals		Goals have been met reasonable well			Goals have been met completely	
Sales growth	1	2	3	4	5	6	7
Profitability	1	2	3	4	5	6	7
Return on equity	1	2	3	4	5	6	7
Growth of firm value	1	2	3	4	5	6	7
Amount of dividends	1	2	3	4	5	6	7

F3 Please evaluate the performance of your company compared with similar businesses in your industry.

	Top 20%	Next 20%	Mid 20%	Lower 20%	Lowest 20%
Sales growth	☐	☐	☐	☐	☐
Profitability	☐	☐	☐	☐	☐
Return on equity	☐	☐	☐	☐	☐
Growth of firm value	☐	☐	☐	☐	☐
Competitiveness as a whole	☐	☐	☐	☐	☐

F4 Please evaluate the average percentage of the net profit on sales of your company during the last 3 years.

☐ maximum 5% ☐ 5-10% ☐ 10-15% ☐ 15-20% ☐ more than 20%