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DO AGENCY COSTS INHIBIT FOREIGN COLLABORATIONS BY FAMILY FIRMS? AN EMPIRICAL INVESTIGATION

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INTRODUCTION

All business is global in the sense that family owned domestic firms face global competition. Consequently, a family owned manufacturing or service firm that seeks to thrive in a highly competitive environment has to construct a long-term strategy that incorporates all the direct and indirect costs of operation on a global basis.

However, a family owned business may not evaluate these global opportunities adequately due to several agency concerns. Family firms may have serious concerns about control, coordination and accountability that could potentially inhibit international collaborations. This project will investigate whether these agency cost concerns impede international collaborations.

Anderson and Reeb (2003) found that out of the sample of 500 S&P firms, family ownership is substantial in one third of the firms, and outstanding family firm equity is 18%. They discovered in this sample that contrary to popular wisdom, family firms perform better than nonfamily firms. When family members serve as CEOs, the performance is superior compared to when nonfamily CEOs are appointed. This suggests that family ownership is an effective form of organization and that family management may not be subject to significant hubris.

LITERATURE REVIEW

The International Business (IB) literature has an extensive analysis about the strategic role of globalization in overall business operations. IB researchers frequently hypothesize that a firm’s tangible and intangible assets play an important role in international expansion. There is also broad IB literature on issues related to international strategy and modes of entry. For instance, Benito and Welch (1997) have summarized the extensive research that seeks to identify the factors that determine the entry mode and the learning curve in understanding foreign markets. Anderson and Gatignon (1986) have identified the reasons why firms might prefer a low-control mode (sub-contracting or licensing) compared to a high-control alternative (a joint venture or a fully owned subsidiary). Typically a firm will prefer a more high-control mode if the expected transaction costs (internal and external uncertainty, free-riding potential, value of firm specific knowledge, etc.) are relatively high. Strategic factors such as the benefit of scale economies, the geographical proximity of different locations, and marketing linkages may also dictate a higher degree of control. Family firms seeking international collaboration need to balance these competing needs along with specific agency concerns about control and coordination.

Nordic researchers [(Johansen and Vahlne, 1990); (Johansen and Wiedersheim-Paul, 1975)] have stressed the strategic importance of knowledge and experience for reducing risk and uncertainty. From a strategic point of view, the extent of resource commitment for foreign collaboration by a manufacturing company should go hand in hand with progressively more knowledge and experience. This literature demonstrates that a critical component of the strategy has to be the identification and strengthening of a network of relationships that are important for long term sustainability. This network would include government officials, banks, local unions, trade organizations, and focus groups of foreign customers. At least initially, family firms may not have adequate knowledge, experience, and required network relationships that are the foundation for successful international collaborations.

For a family firm with limited resources, an incremental approach may hold more promise so that resource commitments, knowledge, and experience can keep pace with competing needs. The initial part of the strategy may involve acquiring relevant knowledge, working out the lean math to increase efficiency and reduce costs, hiring key personnel for developing linkages, and developing foreign marketing networks with progressively more resource commitments as knowledge and experience grows. The mode of entry can perhaps start as subcontracting or licensing and progressively move toward high-control such as joint-venture and eventually owning a fully owned subsidiary as the firm progresses on the learning curve.

Sharma (2004) has conducted an extensive literature analysis of family firms based on 217 refereed articles. Her review indicates that there are very few articles analyzing issues related to international collaboration by family firms.

Zahra (2003) also points out there has been very little analysis of the factors that influence family firms' globalization efforts. Based on a survey of 409 U.S. firms, Zahra found that the *percentage share of family ownership* in business is positively correlated with the *level of internationalization*. The two measures of internationalization used in his study are the amount of international sales and the number of countries with foreign collaboration. In his study, family involvement in management had a mixed effect on internationalization: it had a positive effect on international sales but a negative effect on the number of countries with foreign collaboration. It appears that family owners approach internationalization with caution. The exact reasons for this cautious approach have not been investigated. It seems concerns about agency costs are probably a factor impeding international collaborations. However, this important issue has not been explored.

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METHODOLOGY

The major impediment for research on family firms is the availability of broad and reliable data sets. Most studies tend to employ a survey design in order to obtain insights from primary data. Also, studies based on survey data that analyze the key motivations of potential investors are ideally suited for analyzing qualitative factors that may be difficult to capture by objective data sets. A good example of this approach is the recent study performed by Zahra (2003). The next section will specify the research hypothesis.

RESEARCH OBJECTIVE

In order to function effectively, whenever a family owned business delegates some executive authority to an agent different types of concerns are bound to arise. Typical agency concerns are: Compromising the firm's mission, adequate monitoring of quality, losing control of critical decisions, and potential violations of confidentiality, etc. These agency concerns might be quite different in a domestic environment compared to when dealing with foreign collaboration.

A targeted survey of family owned business firms was conducted to get at their agency concerns and how these concerns inhibit their plans (or lack thereof) for foreign collaborations. The existing database of 1350 family firms that has been created by the Seidman Family Owned Business Institute was utilized

The following areas are explored: First, the type of family involvement in different firms is assessed. Second, concerns about agency costs are investigated. Third, questions are asked about existing organizational structures to reduce monitoring costs and potential conflict. Fourth, questions about existing and potential international collaboration are asked along with agency concerns of working with foreign partners. Information in these four areas allows us to test the following hypotheses:

Hypothesis 1: **More family control** is associated with **higher agency concerns.**

There is obviously a <u>wide range</u> of family involvement in firms and many diverse agency concerns. The first hypothesis will test the extent to which these two issues are correlated.
Normally more agency concerns should result in higher family involvement.

Hypothesis 2**: Specific types of international collaboration** is impeded by **agency concerns** that may arise with foreign partners.

Agency concerns that tend to surface with foreign collaboration should be assessed separately. We will assess is these agency concerns impede different types of foreign collaboration. Foreign collaboration could range from a sales agreement to a joint vesture and a foreign subsidiary. Consequently, it is important to distinguish about the different levels of collaboration.

Hypothesis 3: What is the main rationale for international collaboration? Reducing costs or potential sales growth.

The IB literature points out that international collaboration could be driven not only by trying to reduce the cost of production but also by the potential for larger markets. We will asses if for family owned firms seeking broader markets or reducing overall costs is the main driver for foreign collaboration.

PRELIMINARY RESULTS

Based on the existing database of 1350 family firms that has been created by the Seidman Family Owned Business Institute, a mail survey was sent out to 650 family owned firms.

Approximately 131 usable survey instruments were obtained. The results of the survey instruments are preliminary. By family members we mean individuals connected by either bloodline or by marriage.

Descriptive Data Analysis

The survey was completed mostly by family members (92% of the respondents) who were either owners (24%) , presidents (46%) or vice-presidents (12%). In order to provide a comprehensive assessment of family influence the F-PEC scale of Power, Experience, and Culture was employed. In terms of position, Table 1 indicates that 89% of the ownership was by family members working in the firm. Approximately, 84% of the management team were either family members working or not working in the firm. About 75% of the Board members came from the family. All these dimension indicate a significant concentration of family power.

Table 1. Extent of Family Control.

	No. of respondents	Family members working in firm	*No. of respondents*	Family members <u>not</u> working in firm
What percent ownership (in terms of total assets) of the firm is from:	137	89%	137	7.8%
What percentage of the management team (CEO, CFO, managers, or major executives) is from:	135	73.9%	134	10.2%
What percentage of the Board members is from:	137	67.5%	137	7.1%

In terms of the second construct of the F-PEC scale, experience, approximately 76% of the management team comes from the first generation. 71% of the Board members are from the first generation. This indicates that a vast majority of the family business in the Grand Rapids area are first generation. The average age of the firms is 45 years, indicating considerable experience within the first generation. The average number of employees is 145. In order to delve more deeply into the type of experience, Table 2, makes clear that the higher order functions such as determining the overall goals\mission are accomplished mostly by the Board. Lower order functions such as hiring specific employees are performed mostly by executive officers. Although, the striking feature of Table2 is that the Board and the Executive offices have a significant overlap of most functions indicating considerable power sharing.

Table 2. Organization structure. Which officers determine the tasks specified below?

	Governing Board/CEO		Executive Officers	
Determining overall goals and mission	86	[61%]	67	[48%]
Major budget allocation priorities	75	[54%]	77	[55%]
Overall decisions about the number of employees	53	[38%]	97	[69%]
Decisions about operational expenditures	60	[43%]	94	[67%]
Hiring of specific employees	43	[31%]	103	[74%]

The third component of the F-PEC scale, family culture is a difficult attribute to measure. The respondents indicate that there is some disagreement about business goals\policies, only 54% indicate there is almost always an agreement (Table 3). There is a strong sense of family loyalty, 81% almost always feel a loyalty to their business. There is almost always a sharing of values and support of major decisions by about two thirds of the respondents.

Overall at least in term of the perception of respondents, there appears to be a strong tradition of family loyalty and values.

Table 3. Family Culture.

	Total Responses	**Almost Always**	**Most of the Time**	**Sometimes**	**Rarely**
Family members agree on business goals, plans and policies	139	[54%]	[38.8%]	[5.8%]	[1.4%]
Family members feel loyalty to the family business	139	[81%]	[15.1%]	[2.8%]	[1%]
Your family and business share similar values	138	[68.7%]	[25.3%]	[5%]	[1%]
Family members really care and support major decisions	138	[68.7%]	[25.3%]	[5%]	[1%]

In order to assess agency concerns, the respondents were asked to evaluate specific issues (Table 4). The results indicate that there are significant concerns about losing control, about potential conflict in the organization, and about delegation of authority among junior executives, since less than a majority indicate that these issues surface rarely. On the other hand, there seems to be relatively less concern about diluting the firm's mission and goals, 62% indicate that it is rarely a problem. In general, there does not appear to be widespread agency concerns among family firms.

Table 4. Perceived concerns within firm.

	Total Responses	Almost Always	Most of the Time	Sometimes	Rarely
Do you have concerns about losing control when authority is delegated?	140	[1%]	[7.7%]	[42.8%]	[48.5%]
Do you have concerns of ongoing sources of potential conflict in the organization?	140	[1.6%]	[8.5%]	[47.1%]	[42.8%]
Are there concerns about diluting the firm goals and mission when you delegate?	140	[1.5%]	[5.7%]	[30.7%]	[62.1%]
Do you think junior executives are somewhat dissatisfied with the amount of authority they have?	134	[1.6%]	[5.2%]	[49.2%]	[44%]

The extent of foreign collaboration is analyzed next. It is clear from Table 5 that the main from of foreign collaboration is either having a sales agreement (17%) or a sales representative (12%) in a foreign country. Only 7% of the respondents have a joint venture and even less (4%) have a foreign subsidiary. The pattern seems to indicate a lower level of foreign collaboration and a certain reluctance to proceed to a joint venture or having a foreign subsidiary. Since only 31% of the respondents export their output this pattern is not surprising.

Table 5. Existing or proposed foreign collaboration.

What kind of international collaboration do you currently have?

	Existing	Proposed	None	No. of Countries	
				Total responses	Mean
Sales agreement with a foreign partner	17%	2%	80%	17	2.5
Sales representative in a foreign country	12%	1%	86%	12	5.6
Joint venture in another country	7%	1%	91%	9	1.2
Foreign subsidiary with a foreign partner	4%	1%	94%	5	1.1
Other (please specify)	1%	1%	98%	6	2

Table 6 indicates that the major rationale for foreign collaboration is not the traditional reduction of costs (only 28% rate this as very important) but rather of increasing market share in the long run (43% rate this as very important). In line with the new developments of the international business literature, family firms are recognizing that they have to have some form of foreign collaboration to grow their markets internationally. The major rationale they have validates why they have a preference for having a sales agreement or sales representative.

Table 6. Rationale for foreign collaboration.

Rate the following reasons for foreign collaboration according to how beneficial they would be for your firm:

(Please check appropriate box)

	Total Responses	**Unimportant**	**Somewhat Unimportant**	**Indifferent**	**Somewhat Important**	**Very Important**
Reducing production costs	92	[30.43%]	[5.43%]	[15.22%]	[20.65%]	[28.27%]
Servicing existing markets	96	[25.00%]	[1.04%]	[16.67%]	[20.83%]	[36.46%]
Potential sales growth	96	[20.83%]	[1.04%]	[10.42%]	[25.00%]	[42.71%]

Table 7 indicates that the lack of foreign collaboration seems to be primarily driven by concerns about enforcing agreements, difficulty of monitoring quality, and concerns about foreign imitation of their product. More than 18% of the respondents indicate these three issues as major agency concerns. On the other hand, concerns about diluting the firm's mission or maintaining harmony in the organization are valid but not very strong concerns.

Table 7. Reasons for lack of foreign collaboration.

Do you think foreign collaboration by your firm is impeded by the following factors?

(Please check appropriate box)

	Total Responses	**Unimportant**	**Somewhat Unimportant**	**Indifferent**	**Somewhat Important**	**Very Important**
Concerns about enforcing agreements	86	[32.56%]	[8.14%]	[20.93%]	[19.77%]	[18.60%]
Concerns about dilution of firm's priorities	85	[40.00%]	[11.76%]	[29.41%]	[16.48%]	[2.35%]
Difficulty in monitoring product quality	86	[36.00%]	[4.70%]	[18.60%]	[22.10%]	[18.60%]
Concerns about foreign firms imitating product	85	[41.20%]	[9.40%]	[15.30%]	[15.30%]	[18.80%]
Concerns about maintaining harmony in your organization	45	[45.90%]	[8.20%]	[21.20%]	[14.50%]	[8.30%]

EMPIRICAL RESULTS

Hypothesis 1: More family control is associated with higher agency concerns.

In Table 8, the percentage of ownership (total assets) by family members is regressed against the concerns firms have about losing control when authority is delegated. The age of the firm and the number of employees is used as control variables. The results indicate that an older firm has less ownership by family members, although the t-value is not significant at the five percent level (-1.16). Agency concerns about losing control when delegating is significantly associated with the degree of family ownership (t value = 1.97).

Although family control and agency concerns are evaluated by many dimensions, it is difficult to include dummy variables of each dimension due to strong multicollinearity. Consequently, composite variables are constructed that capture two dimensions for an alternative test. In this case, the composite variable for family control is percentage of family ownership of total assets by family members plus percentage of the governing board represented by family members. Agency concern is also represented by a composite variable (concerns of losing control by delegation plus perception that junior executives are dissatisfied with amount of authority they have). The results depicted in Table 1 indicate that these agency concerns are significantly associated more family control in terms of ownership and board representation (t value = 2.12). The preliminary results tend to support Hypothesis 1.

Hypothesis 2: Specific types of international collaboration is impeded by agency concerns that may arise with foreign partners.

International collaboration can take many forms such as sales agreement with a foreign partner, sales representative in foreign country, joint venture in another country, and foreign subsidiary with a foreign partner. However, we know from the descriptive data that most family firms that have international collaboration normally have a sales agreement or a sales representative. In the first instance, the existence of a foreign sales agreement is regressed against concerns of enforcing agreements for foreign collaboration (Table 9). Again age of firm and number of employees are used as control variables. The results indicate that concerns about enforcing agreements is significantly positively correlated with the existence of having a sales agreement (t value = 2.26). A similar result is obtained for sales representative as a dependent variable (T-value of 1.84 for concerns about enforcing agreements). A composite variable of either as sales representative or sales agreement results in a t-value of 2.42. This seems to be counter intuitive. However, when concern about enforcing foreign agreement is regressed against either having a joint venture or a foreign subsidiary, the relationship is negative and statistically insignificant. Recall that family firms that have foreign collaboration typically have either a sales representative or agreement, consequently these results should not be surprising.

The pattern of results indicate that concerns about enforcing a foreign agreement are positively related to having a sales agreement but negatively related to joint ventures or having foreign subsidiaries. The preliminary results indicate that agency concerns with foreign collaborators tend to make family owned firms have a lower order of international collaboration (foreign sales agreement or sales representative) compared to a more significant commitment (joint venture or foreign subsidiary).

Hypothesis 3: What is the main rationale for international collaboration? Reducing costs or potential sales growth.

Given the fact that most of the foreign collaboration is in the form of a sales representative or sales agreement, we constructed a composite foreign collaboration variable that includes firms having either a sales agreement or representative (Table 10). When this composite variable is regressed against two different rationales for international collaboration, reducing production costs or potential market growth, it becomes clear that the main motivation for having different types of foreign collaboration is not the traditional reduction of costs but the lure of potentially larger sales growth.

A more generalized composite variable by summing up the existence of a sales agreement with a foreign partner, sales representative in foreign country, joint venture in another country, and foreign subsidiary with a foreign partner leads to a similar result.. This preliminary result indicates that consistent with the IB literature, family firms are using the opportunities of international collaboration not only to reduce costs but also to extend their market reach.
In both instances, the number of employees is significant at the one percent level, indicating that larger firms tend to have more foreign collaboration. This result is consistent with the general finding that internationalization is an incremental process and smaller firms have difficulty establishing international linkages.

CONCLUSION

The preliminary results indicate the following pattern:

1. Domestic agency concerns results in greater amount of family control.
2. International agency concerns tend to result in family firms having a lower level of foreign collaboration such as a sales representative or a sales agreement.
3. The main motivation for foreign collaboration seems to be extending markets rather than reducing costs. Typically, larger firms tend to have more foreign collaboration.

It should be emphasized that these results are based on a relatively small sample and are preliminary. More studies of family owned firms need to be conducted to corroborate the findings.

Table 8. Agency concerns and firm control.

DEPENDENT VARIABLE: PERCENT OWNERSHIP BY FAMILY

Source	SS	df	MS
Model	2822.09633	3	940.698776
Residual	54552.3089	127	429.545739
Total	57374.4052	130	441.341579

Number of obs =	131
F(3, 127) =	2.19
Prob > F =	0.0924
R-squared =	0.0492
Adj R-squared =	0.0267
Root MSE =	20.725

	Coef.	Std. Err.	t	P>|t|	[95% Conf.	Interval]
LOSING CONTROL	5.332022	2.711359	1.97	0.051	-.0332677	10.69731
AGE FIRM	-.0695989	.0602436	-1.16	0.250	-.1888101	.0496123
EMPLOYEES	-.0042005	.0053223	-0.79	0.431	-.0147323	.0063313
CONSTANT	83.95801	5.559159	15.10	0.000	72.95743	94.95858

DEPENDENT VARIABLE: PERCENT (OWNED BY FAMILY AND BOARD MEMBERS)

Source	SS	df	MS
Model	13879.5276	3	4626.5092
Residual	300506.691	118	2546.66687
Total	314386.218	121	2598.23321

Number of obs =	122
F(3, 118) =	1.82
Prob > F =	0.1479
R-squared =	0.0441
Adj R-squared =	0.0198
Root MSE =	50.465

	Coef.	Std. Err.	t	P>|t|	[95% Conf.	Interval]
AGENCY CONCERN	9.169105	4.329797	2.12	0.036	.5949288	17.74328
FIRM	-.0408447	.149559	-0.27	0.785	-.3370123	.2553229
EMPLOYEES	-.0094367	.0139082	-0.68	0.499	-.0369787	.0181052
CONSTANT	128.0678	16.44012	7.79	0.000	95.51184	160.6237

Table 9. Foreign collaboration and agency concerns.

DEPENDENT VARIABLE: FOREIGN SALES AGREEMENT

Source	SS	df	MS		
Model	1.82845152	3	.609483839	Number of obs =	84
Residual	13.9215485	80	.174019356	F(3, 80) =	3.50
Total	15.75	83	.189759036	Prob > F =	0.0191
				R-squared =	0.1161
				Adj R-squared =	0.0829
				Root MSE =	.41716

	Coef.	Std. Err.	t	P>|t|	[95% Conf.	Interval]
ENFORCEMENT	.0690499	.0305193	2.26	0.026	.0083145	.1297852
AGE FIRM	.0003079	.0018171	0.17	0.866	-.0033082	.0039239
EMPLOYEES	.0002527	.0001072	2.36	0.021	.0000394	.0004661
CONSTANT	.0031462	.129221	0.02	0.981	-.2540118	.2603042

DEPENDENT VARIABLE: FOREIGN SALES REPRESENTATIVE OR AGREEMENT

Source	SS	df	MS		
				Number of obs =	84
				F(3, 80) =	5.88
Model	7.68651587	3	2.56217196	Prob > F =	0.0011
Residual	34.8849127	80	.436061409	R-squared =	0.1806
				Adj R-squared =	0.1498
Total	42.5714286	83	.512908778	Root MSE =	.66035

FC	Coef.	Std. Err.	t	P>|t|	[95% Conf.	Interval]
Enforcement	.1168546	.0483114	2.42	0.018	.0207118	.2129974
Age Firm	.003129	.0028764	1.09	0.280	-.0025951	.0088532
Employees	.0005039	.0001697	2.97	0.004	.0001661	.0008416
cons	-.1166337	.2045541	-0.57	0.570	-.5237094	.290442

Table 10. Rationale for foreign collaboration.

DEPENDENT VARIABLE: FOREIGN SALES REPRESENTATIVE OR AGREEMENT

Source	SS	df	MS
Model	10.6670982	4	2.66677454
Residual	35.2430142	84	.419559693
Total	45.9101124	88	.521705822

Number of obs	= 89
F(4, 84)	= 6.36
Prob > F	= 0.0002
R-squared	= 0.2323
Adj R-squared	= 0.1958
Root MSE	= .64773

FC	Coef.	Std. Err.	t	P>|t|	[95% Conf.	Interval]
PROD.COSTS	.0517089	.048699	1.06	0.291	-.0451344	.1485522
SALESGROWTH	.137319	.0504506	2.72	0.008	.0369924	.2376455
AGE OF FIRM	-.0005441	.0024109	-0.23	0.822	-.0053384	.0042502
EMPLOYEES	.0004153	.0001671	2.49	0.015	.0000831	.0007475
CONSTANT	-.2596056	.2008322	-1.29	0.200	-.6589825	.1397712

DEPENDENT VARIABLE: GENERAL FOREIGN COLLABORATION

Source	SS	df	MS
Model	25.2618829	4	6.31547072
Residual	65.9740722	84	.785405621
Total	91.2359551	88	1.03677222

Number of obs	= 89
F(4, 84)	= 8.04
Prob > F	= 0.0000
R-squared	= 0.2769
Adj R-squared	= 0.2425
Root MSE	= .88623

fc	Coef.	Std. Err.	t	P>|t|	[95% Conf.	Interval]
PROD. COSTS	.0010624	.0666301	0.02	0.987	-.1314388	.1335636
SALESGROWTH	.2124365	.0690266	3.08	0.003	.0751695	.3497035
AGE OF FIRM	-.0002236	.0032986	-0.07	0.946	-.0067832	.006336
EMPLOYEES	.0008301	.0002286	3.63	0.000	.0003755	.0012846
CONSTANT	-.2868634	.274779	-1.04	0.299	-.8332915	.2595647

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