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# Comparing the Agency Costs of Family and Non-Family Firms: Conceptual Issues and Exploratory Evidence

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**Family involvement in a business has the potential to both increase and decrease financial performance due to agency costs. In this article we discuss the different nature of agency costs in family firms and specify the combination of conditions necessary to determine the relative levels of agency costs in family and non-family firms through the impacts of agency cost control mechanisms on performance. We also present exploratory results based on a study of 1,141 small privately held U.S. family and non-family firms that suggest the overall agency problem in family firms could be less serious than that in non-family firms.**

## Introduction

Although there is no consensus about the relationship between organizational performance and the ownership and control of a firm (James, 1999), most scholars agree that separation of ownership and management creates costs that may not exist if ownership and management were combined. Agency theory is based on the idea that managers who are not owners will not watch over the affairs of a firm as diligently as owner-managers. Ross (1973) formalized this conflict of interest arising from the separation of ownership and management as a principal-agent problem and Jensen and Meckling (1976) coined the phrase “agency costs” to represent the costs of all activities and operating systems designed to align the interests and/or actions of managers (agents) with the interests of owners (principals). Myers (1977) and Smith and Warner (1979) showed that agency costs also exist in the owner-lender relationship while Morck, Shleifer, and Vishny (1988) documented the potential agency costs to minority shareholders from having an entrenched dominant shareholder.

Traditionally, researchers have assumed that owner-managed firms will have either zero or insignificant agency costs (Jensen & Meckling, 1976; Fama & Jensen, 1983; Ang,

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Cole, & Lin, 2000). There is a tendency to extend this to family firms because family members are expected to be altruistic toward each other as a result of kinship obligations that are part of the axiomatically binding normative moral order in most cultures (Stewart, 2003).<sup>1</sup> Altruism could mitigate some agency costs (Wu, 2001) but, unfortunately, altruism could also lead to other agency costs, for example, free riding by family members as in the “Samaritan’s dilemma” (Bruce & Waldman, 1990), entrenchment of ineffective managers (Morck et al., 1988), or even predatory managers (Morck & Yeung, 2003).

Two recent articles (Schulze et al., 2001; Schulze, Lubatkin, & Dino, 2003) posit that altruism may create agency problems unique to family firms because family relationships make it more difficult to resolve certain kinds of conflicts and curb unproductive behaviors. They further propose and empirically confirm that, because of these problems, family firms will gain performance benefits from the use of pay incentives and other agency cost control mechanisms such as strategic planning (Schulze et al., 2001, 2003).

Since nepotism does exist (Ewing, 1965) and families find it difficult to replace ineffective family members (Handler & Kram, 1988), it is hard to deny that family involvement has the potential to lower economic performance, particularly in light of Schulze et al.’s (2001, 2003) research. But agency costs arise only when firm actions contravene owners’ interests or when resources must be expended to ensure that firm actions do not contravene owners’ interests. For example, if family business owners wish to provide a minimum standard of living for relatives, any decrease in economic performance due to nepotism cannot be considered an agency cost. Thus, the nature of agency costs in family firms deserves more careful consideration.

The purpose of this article is to take another step toward a better understanding of agency costs in family firms by: (1) examining differences in the nature of agency costs in family and non-family firms; (2) discussing conditions that must be met in order to empirically examine agency costs in family firms through the impacts of agency cost control mechanisms on performance; and (3) presenting results of an exploratory study of the impact of agency cost control mechanisms on the relative economic performance of family and non-family firms.

## An Overview of Agency Theory

Agency theory (Ross, 1973; Eisenhardt, 1989) is concerned with the conflicts of interest between an agent acting as a representative of a principal. Theoretically, it arises from divergent interests and asymmetric information. If both parties have the same interests, then there is no conflict of interest and no agency problem (Jensen & Meckling, 1976). In many instances, however, the two parties will have different interests. Furthermore, an agent will typically possess more or better information than the principal about the agent, the decision situation, or the consequences of actions (Ross, 1973).

As a result of asymmetric information, agency problems fall into two basic categories: *adverse selection* and *moral hazard*. Adverse selection occurs when the principal inadvertently contracts with an agent who is less able, committed, industrious, or ethical, or whose interests are less compatible than the principal expected.

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1. Following Chua, Chrisman, and Sharma (1999, p. 25), we define family business as “a business governed and/or managed with the intention to shape and pursue the vision of the business held by a dominant coalition controlled by members of the same family or a small number of families in a manner that is potentially sustainable across generations of the family or families.”

Moral hazard, on the other hand, involves commission or omission of actions, after contracting that work in the interest of the agent but are detrimental to that of the principal. Examples of omission and commission include, respectively, shirking (Ross, 1973) and the consumption of perks (Jensen & Meckling, 1976). Conceptually, if information is perfect and costless, and people are unbounded in their mental capabilities, then principals and agents can write a *complete contract* that anticipates and provides for every eventuality (Williamson, 1975). There will be few or no moral hazard problems because an agent cannot engage in opportunistic behavior without suffering the consequences enforceable by the principal under the contract.

In reality, people have bounded rationality: their capacity to process information, deal with complexity, and identify and pursue optimal actions is limited (Simon, 1957). The outcome is an *incomplete contract* between principal and agent (Williamson, 1975). Furthermore, information is imperfect and costly to obtain. For example, whether agents are exerting their full creative efforts is not easy to determine.

To control the adverse selection problem, principals have to incur higher search and verification costs. To control the moral hazard problem, principals must use an optimal combination of incentives, punishments, bonding, and managerial processes to align interests and monitor agents' actions. These constitute the agency costs of dealing with principal-agent relationships and we refer to the processes, systems, and structures set up for such purpose of monitoring and alignment of interests as *agency cost control mechanisms*. These costs and mechanisms apply to all sources of agency problems. For example, in the owner-lender conflict, agency concerns require lenders to set up criteria and costly procedures to screen borrowers, set interest rates and other terms, evaluate and tie up collateral, train lending staff, and establish collection systems.

In summary, agency problems arise when principal-agent relationships are characterized by divergent utility functions and informational asymmetries. Agency-related costs arise from the consequences of agents' behaviors that are not in the interests of principals and from the expenses incurred for the activities and systems set up by principals to control agents' behavior.

### **Agency Costs in Family Firms**

According to some observers (Becker, 1974; Jensen & Meckling, 1976; Parsons, 1986; Eisenhardt, 1989; Daily & Dollinger, 1992), family firms should, by virtue of their intra-familial altruistic element, be exempt from problems of agency. Taken to the extreme, Jensen and Meckling (1976) go so far as to propose that family firms are qualitatively different enough from non-family firms as to make formal governance unnecessary, and at times even counter-productive. Daily and Dollinger (1992) and Kang (2000) follow this rationale to its logical endpoint, proposing that the practical implications of familial altruism and reliability mean that family firms are the least costly and most efficient form of organization. Ang et al. (2000), for example, propose the sole-owner managed firm as the zero agency cost base case.

Becker's (1974) treatise on the family provides a theoretical rationale for such a possibility. He argues for a family's special exemption from the problems of agency by stating, "[family] members are motivated to maximize family income and consumption, even if their welfare depends on their own consumption alone" (1974, p. 1080). In the spirit of such clan-based collegiality, Parsons (1986) hypothesizes an inherent absence of agency-related problems where family is involved. Likewise, Eisenhardt (1989, p. 64)

writes, "Clan control implies goal congruence between people, and therefore, the reduced need to monitor behavior or outcomes. Motivation issues disappear."

A family, however, is not a monolithic or homogeneous group of people with congruent interests, nor are all family businesses identical with respect to organizational characteristics and behaviors (Sharma, Chrisman, & Chua, 1997). As a result, some family firms may be particularly vulnerable to problems of agency. Bergstrom (1989) challenges Becker's (1974) postulate of familial altruism and proposes that the assumption of intra-family goodwill collapses under conditions of information asymmetry. He concludes that we are more likely to observe children shirking than working. Family firms also face challenges unbeknownst to their non-family counterparts because of their comparative private and self-dealing tendencies (Litz, 1997; Schulze et al., 2001). La Porta, Lopez-de-Silanes and Shleifer (1999, p. 510) see this characteristic as particularly troublesome and argue that family enterprises are uniquely predisposed to internal dysfunction, in large part because the autonomy of the controlling shareholders in decision-making "keeps the potential whistle-blowers out of major corporate decisions, and thus reduces the risk of getting caught."

Schulze et al. (2001) suggest that parents' altruism will lead them to be generous to their children even when the latter free ride and lack the competence and/or intention to sustain the wealth creation potential of the firm. Schulze et al. (2003) also note that altruism may bias perceptions of parent-CEOs regarding the performance of family agents and may make it more difficult to punish poor performance, particularly when such punishment has spillover effects on family relationships outside the business. Hendry (2002) recently conceptualized agency-related problems arising from honest incompetence. Family firms appear particularly vulnerable to honest incompetence and deficits of expertise because they often have a self-imposed personnel selection criterion that gives preferential treatment or, in the extreme, exclusive consideration to family stakeholders. All these possibilities suggest family firms are anything but immune to the problems of principal-agent dysfunction.

Underlying all of the above observations about agency problems in family firms, is the implicit assumption that economic performance is their sole goal. But it is generally acknowledged that family firms may have both economic and non-economic goals (e.g., Lee & Rogoff, 1996).

Agency costs are created only when managers pursue their own interests contravening those of the owners. Therefore, if owners wish to divert resources to pursue noneconomic goals and managers conform to such wishes, there may be diminished economic performance but no agency cost. If a family decides that providing jobs for its less able members is in its interest and management does provide the jobs, there is consumption of perks, which would be an agency cost in a non-family firm, but not in a family firm. Besides, pursuance of utility that includes non-economic considerations does not, per se, create economic inefficiency (Jensen & Meckling, 1994). As a result, agency costs in a family firm cannot be identified, let alone measured, without an expansion of its goal set to include benefits unrelated to financial and competitive performance.

This is not simply a theoretical matter; it could have important implications for economic development. For example, Eaton, Yuan, and Wu (2002) have provided some theoretical results showing how this could lead to a competitive advantage for a family firm. In a similar vein, Chua and Schnabel (1986) show that when investments yield both pecuniary and non-pecuniary return, the equilibrium pecuniary return will be lower for these investments because the holders of these investments will receive additional compensation through the non-pecuniary return. This means that families deriving non-pecuniary returns from their involvement in family firms may have a lower pecuniary cost of equity

capital, which may partially explain the predominance of family firms in the global economy.

In summary, agency issues arising from the separation of ownership and management may be different in family firms because of their non-economic goals. However, agency costs can still arise from lender-owner and majority-minority owner conflicts of interests. A study of agency costs in family firms must also take into account these other sources of agency problems. In the following section, we discuss agency costs from all sources of principal-agent conflicts.

### An Accounting of Agency Costs

Assuming agency costs are different in family and non-family firms, a comparison of those costs can be expressed by the following inequality, with the subscript F representing agency costs for family firms and NF for non-family firms.

$$ALT_F + OM_F + OL_F + DM_F \neq ALT_{NF} + OM_{NF} + OL_{NF} + DM_{NF}$$

Where: ALT = Agency costs arising from asymmetric altruism.

OM = Agency costs arising from separation of ownership and management.

OL = Agency costs arising from conflict of interests between owners and lenders.

DM = Agency costs arising from conflict of interests between dominant and minority shareholders.

Family firms will have higher agency costs if the sum on the left-hand side of the inequality above is greater than that on the right-hand side. Assuming that there is no altruism in non-family firms, then  $ALT_F$  would be higher than  $ALT_{NF}$  if altruism indeed generates agency costs as suggested by Schulze et al. (2001, 2003).

If both types of firms are dominant owner managed, as is often the case in privately held firms, then  $OM_{NF}$  and  $OM_F$  will approach zero because there is no separation of ownership and management.<sup>2</sup> If, on the other hand, family firms tend to be owner managed while non-family firms tend to be managed by non-owners, as is typically the case in publicly held firms, then  $OM_{NF}$  should be higher than  $OM_F$ .

If lenders treat family and non-family firms the same then  $OL_{NF}$  and  $OL_F$  will be equal, *ceteris paribus*. However, if, for example, family members are more willing to make sacrifices, pool resources, or invest additional equity when the firm faces a financial crisis, then  $OL_{NF}$  will be higher than  $OL_F$ . This tendency may be strongest if the family's stake in the business represents a significant proportion of their wealth. Anderson, Mansi, and Reeb (2003) find that this is indeed the case.

If the share distributions in family and non-family firms are different, as would be the case if one compared privately held family firms with publicly owned non-family firms, then  $DM_{NF}$  and  $DM_F$  will potentially be different. Even among privately held firms there may be differences if the family firms being considered are owned exclusively by family members. In either case,  $DM_F$  may be lower than  $DM_{NF}$ .<sup>3</sup> On the other hand, if a

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2. Here we take the simple case of a single manager who is also the owner of the firm. Even in such cases agency costs will only approach but not reach zero because employees may act opportunistically and small firms often lack even the most rudimentary mechanisms to control employee behavior. Furthermore, owner-managed firms with additional managers who are not owners may have non-zero agency costs whether there is or is not family involvement.

3. This is a conjecture. We are unaware of any systematic evidence on this issue, particularly in regard to differences between family and non-family firms that are privately owned.

family business has both family and outside shareholders, family involvement may generate unique agency costs (Slator, 2002). Thus, the inequality depicted above cannot be determined conceptually; whether family firms have higher or lower total agency costs than non-family firms is an empirical question.<sup>4</sup>

## Measuring Agency Costs in Family Firms

As discussed above, agency costs are costs incurred by a firm to ensure that agents act in the interests of principals. Consequently, the conclusive way to identify sources and costs of agency is to study directly the decisions and behaviors of principals and agents in family firms. It must then be determined whether the motivations for those decisions and behaviors are related to aligning manager actions with owner interests, reconciling owner actions and lender interests, resolving conflicts between majority and minority shareholders, or altruism. Finally, the costs of such activities must be measured and assigned accordingly.

Instead of measuring directly the costs of activities designed to deal with agency problems, researchers typically establish the presence of agency costs by observing the relationships between these activities and performance. The assumption is that these activities should improve performance because the benefits from controlling agency problems will be lower than the costs. Unfortunately, the relationships between performance and interest alignment activities, such as strategic planning and board of directors, could have other possible explanations (e.g., Ford, 1988; Schwenk & Shrader, 1993; Ward, 1988).

## Agency Cost Control Mechanisms and Performance

Performance should be measured in terms of the goals set by a family firm; conceptually, this is the same whether one is measuring performance in terms of economic or non-economic goals. Mathematically, if we assume that performance (Perf), family involvement (F), and the utilization of agency cost control mechanisms (CM) are variables that can be measured along a continuous dimension and are differentiable, their impacts on overall economic and non-economic performance, assuming that such an overall measure is feasible, may be expressed as:

$$\begin{aligned} \Delta \text{Perf} = & \frac{\partial \text{Perf}}{\partial F} \Delta F + \frac{\partial \text{Perf}}{\partial \text{CM}} \Delta \text{CM} + \frac{\partial^2 \text{Perf}}{\partial^2 \text{CM}} (\Delta \text{CM})^2 + \frac{\partial^2 \text{Perf}}{\partial^2 F} (\Delta F)^2 \\ & + \frac{\partial \text{Perf}}{\partial \text{CM} \partial F} (\Delta \text{CM})(\Delta F) \end{aligned}$$

where  $\Delta$  indicates incremental change. Dropping the two second-order terms, we get:

$$\Delta \text{Perf} = \frac{\partial \text{Perf}}{\partial F} \Delta F + \frac{\partial \text{Perf}}{\partial \text{CM}} \Delta \text{CM} + \frac{\partial \text{Perf}}{\partial \text{CM} \partial F} (\Delta \text{CM})(\Delta F)$$

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4. It is also possible that the various types of agency costs are related or interact. For example, altruism on the part of owners toward other family members may create OL or DM agency costs. However, exploring this possibility is beyond the scope of this study.

This relationship shows that family involvement and agency cost control mechanisms together will produce three effects on performance.

The first term on the right-hand side of the equation measures the pure effect of family involvement *independent of the influence of agency cost control mechanisms*. If, holding everything else equal and excluding the effects of agency cost control mechanisms, family involvement is a net benefit (detriment), then this effect will be positive (negative). The effect is irrelevant by itself, however, to the question of interest—whether family firms have higher or lower total agency costs—because it specifically excludes the impacts of agency cost control mechanisms, through which we are attempting to measure agency costs. This effect is due to other influences, such as competitive advantages (or disadvantages) produced by resources engendered by family involvement unrelated to controlling agency cost (e.g., Habbershon, Williams, & MacMillan, 2003; Sirmon & Hitt, 2003) and as such must be accounted for in any analysis of agency costs. However, simply showing that family involvement improves (or detracts from) firm performance would not establish that it is due to lower (higher) agency costs or the effectiveness (ineffectiveness) of agency cost control mechanisms.

The second term is the incremental effect of agency cost control mechanisms on performance *independent of family involvement*. This effect should be positive regardless of family involvement as long as agency cost control mechanisms are utilized and yield benefits greater than their implementation costs. Thus, how much the performance of a firm, whether family or non-family, is affected by the use of these mechanisms is a product of the effectiveness of the mechanisms and the extent to which they are used. This is a large part of what is measured when researchers test the relationship between performance and the use of control mechanisms without segregating the two other effects. But this particular effect does not show whether family firms have higher or lower agency costs. Instead, it shows whether or not a control mechanism is effective in improving performance.

The third term measures the incremental combined impact of family involvement and use of the control mechanism. This third effect cannot, by itself, be used to establish whether family firms have higher or lower agency costs because its interpretation depends on the second effect. If the second effect is positive, implying that the agency cost control mechanism has a positive effect on performance, as one would expect, then a positive interaction term (in terms of increasing family involvement and utilization of control mechanisms) implies that family firms have higher agency costs than non-family firms and, thus, benefit more from the mechanism. If the second effect is negative (i.e., the cost of the mechanism exceeds the benefit), a positive third effect implies the opposite. If the second effect is zero, then the third effect should also be zero theoretically; any statistically significant third effect is probably spurious.

In summary, comparing agency costs of family and non-family firms indirectly through the impacts of agency cost control mechanisms such as strategic planning and boards of directors is complex. First, family firms can have better (worse) performance for reasons other than agency costs. Second, the literature suggests that firms employ these managerial mechanisms for dual purposes. These mechanisms can enable any firm, even those managed by stewards rather than agents, to make better strategic decisions in light of its environmental and resource circumstances (e.g., Ford, 1988; Schwenk & Shrader, 1993; Ward, 1988). For those firms with greater agency-related problems, these mechanisms have the additional benefit of augmenting control and reducing agency costs (Jensen & Meckling, 1995). As a consequence of this dual benefit and the performance gap that would exist if such planning and control mechanisms were not in place for firms with higher agency costs, establishing that improvement in performance is due to agency cost control requires the segregation of the three effects.

This discussion segregates the three effects conceptually. Doing it empirically adds complexity. We discuss the empirical issues next.

### **Empirical Issues in Measuring the Three Effects**

Because not all family or non-family businesses are alike, when examining whether family firms have higher total agency costs, a confluence of other factors that could affect performance must be included in the analysis in addition to the three effects discussed above. Some of these factors produce performance differences unrelated to agency costs and family involvement. Typically, empirical studies on economic performance control for these through the use of variables such as age, size, and industry, among others.

There might be other organizational characteristics that influence the types and amounts of agency costs, but are not *necessarily* related to family involvement. Controlling for these effects rigorously will require the inclusion of the determinants of these conflicts. As suggested in our earlier discussion about the sources of agency costs, many of these appear to be largely a function of whether a firm is privately or publicly held.<sup>5</sup> Therefore, testing with a sample of family and non-family firms that are all privately held (or all publicly held), although not a perfect method of isolating agency costs due to the presence or absence of family involvement, should be a good starting point for addressing the problem.

In summary, a cross-sectional test must measure performance differences that are due to the following: (1) family involvement effects independent of agency costs, (2) effectiveness and utilization of agency cost control mechanisms, (3) interaction of family involvement and agency cost control mechanisms, (4) agency cost drivers unrelated to family involvement, and (5) performance drivers unrelated to agency costs and family involvement.

### **Research Questions**

In the remainder of this article we present an exploratory study of agency costs in family versus non-family firms using the framework discussed above. The results are considered exploratory due to several limitations in our data that are discussed later in this article. Because of the exploratory nature of this study, the conflicting theoretical arguments on whether agency costs are higher or lower in family versus non-family firms, and our inability to separate the various types of agency costs that may be present in small, privately held firms, we do not propose formal hypotheses. Instead, we examine a set of questions based on the conceptual guidelines for investigating agency costs developed above. The questions are:

1. First effect: *Do family firms have better performance independent of the effects of agency cost control mechanisms?*
2. Second effect: *Do agency cost control mechanisms, such as strategic planning and boards of directors or advisors, improve performance?*
3. Third effect: *Do agency cost control mechanisms, such as strategic planning and boards of directors or advisors, improve the performance of family firms more or less than that of non-family firms?*

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5. To the extent that family involvement is associated with the tendency for a firm to be privately or publicly held, these effects will be indirectly related to family involvement.

## Methodology

The data are from a larger project designed with a primary purpose of assessing the economic impact of the counseling activities of the Small Business Development Center (SBDC) program in the United States. SBDCs from 48 states participated in the study. In 2000, questionnaires were sent to the entire population of 27,167 small businesses that received five or more hours of counseling assistance from these SBDCs in 1998.<sup>6</sup>

Two mailings of the questionnaire were conducted. A total of 5,800 small business clients (21.3%) returned usable questionnaires. Because the SBDC serves some very small clients we restricted our analysis to those that had above five full-time equivalent employees. This eliminated any self-employed individuals in the sample as well as those of such a small size that to include them would render tests of agency essentially meaningless.<sup>7</sup> We also eliminated outlier firms and responses with missing data. This reduced our effective sample size to 1,141 firms. All of the data were self-reported. No independent verification was possible because the SBDC did not share the identity of the sample firms and the firms were all privately held.<sup>8</sup>

Although we surveyed the entire population of clients, it was not possible to obtain responses from all the members of that population. Tests indicated that there was no significant difference between respondents to the first and second mailings in terms of the variables used in this study: size, age, industry, family involvement, presence of a board of directors, or propensity to engage in strategic planning. Since later responders could be expected to be more similar than earlier responders to non-respondents (Kanuk & Berenson, 1975; Oppenheim, 1966), these tests suggest that there is no reason to conclude that there was bias in any of the key variables analyzed in this study (cf. Hawes & Crittenden, 1984).<sup>9</sup> Despite these precautions, it is possible that biases in our data persist due to causes such as social desirability.

These firms had average base-year sales of \$2.3 million and average base-year employment of 23 full-time equivalent employees. 74% of the firms reported that they had engaged in strategic planning and 75% reported having a board of directors or advisors. These high percentages should be considered reflective of both the types of firms that seek outsider assistance and the advice they received from SBDC. They may not be representative of those in the general population of small firms (Storey, 2000).

## Variables

**Dependent Variable.** Our performance measure was short-term SALES GROWTH measured as the percentage growth in reported sales between 1998 and 1999. Profitability, value, or long-term sales growth would be better measures of performance but these were not available from the survey.

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6. Because the survey, administered by the Association of Small Business Development Centers, from which we extracted our data had a different primary objective we were constrained in our ability to incorporate all of the questions that we desired. Therefore, as noted above, we consider the results of this study to be exploratory in nature.

7. To determine if our choice of size cutoffs influenced our results we ran additional regressions using a variety of different cutoff points. Those results were consistent with the results reported in this article.

8. However, Brush and Vanderwerf (1992) have suggested that self-reported performance data is correlated with objective performance data.

9. We also found no difference between the firms used in the analysis and those for which there was missing data.

**Family Business.** Although there is much disagreement on what constitutes a family business, there does not appear to be much disagreement that firms that are owned and managed by family members and seek to ensure trans-generational involvement through family succession are family businesses (Chua et al., 1999). To operationalize the theoretical definition of family business proposed by Chua et al. (1999), we therefore used the family involvement components of ownership, management, and succession.<sup>10</sup> These constructs were measured, respectively, by the percentage of the business owned by members of the family, the number of family members involved in managing the business, and whether the future successor as president of the business was expected to be a member of the family (Chrisman, Chua, & Steier, 2002).<sup>11</sup>

We used the quick clustering technique in SPSS to separate family and non-family businesses (see Table 1). Family businesses were denoted by scores of “1” and non-family businesses by scores of “0.” Quick clustering is a K-means clustering technique that employs a simple Euclidean distance-sorting method emphasizing distinctions among observations rather than hierarchical relationships. It is more efficient than hierarchical clustering techniques because it does not compute the distances between all pairs of cases. The K-means procedure assumes that the number of clusters that should be derived and the variables that should be used are known. Because we were interested in distinguishing family and non-family firms and could identify the appropriate variables from Chua et al.’s (1999) theoretical definition of family business, the quick clustering technique was considered appropriate.

Our examination of the clusters suggested that the two groups were interpretable and meaningful with respect to both the theoretical definition used and the distinctions between groups for the three variables used to construct the clusters. 79% of the sample firms are classified as family firms. This is higher than the 60% estimated by Shanker and Astrachan (1996) for U.S. partnerships and private corporations combined but lower than their estimate of 92% for all U.S. businesses. It is also consistent with other estimates of the proportion of family firms in the economy found in the literature (Beckhard & Dyer, 1983; Gersick et al., 1997; Westhead & Cowling, 1998; Chrisman et al., 2002).

**Agency Cost Control Mechanisms.** STRATEGIC PLANNING and BOARD (board of directors/advisors) were categorical variables constructed from responses to questions concerning whether the firms had engaged in strategic planning or had created a board of directors or advisors. For each variable a score of “1” was used to denote the presence of an agency control mechanism, and a score of “0” was used to denote its absence.

**Interaction Variables.** The interaction variables were constructed by multiplying the family business variable by the strategic planning variable to form FAMPLAN and by the board of directors/advisors variable to form FAMBOARD, respectively.

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10. The literature on the definition of family business is quite extensive. Therefore, we refer the reader to Chua et al. (1999) for a review. For further discussions on the components of family involvement see Westhead and Cowling (1998) and Astrachan, Klein, and Smyrniotis (2002).

11. Although family involvement per se does not capture the vision or intention that should theoretically distinguish family businesses from non-family businesses, family ownership and management does ensure that the vision comes from the family. Furthermore, the expectation of future family involvement ensures that there is an intention to pursue the family’s vision across generations. Therefore, our operationalization is consistent with the theoretical definition used.

Table 1

Cluster Solution: Family Businesses Versus Non-Family Businesses

	Cluster 1: Mean for Family Business	Cluster 0: Mean for Non-Family Business	F-statistic
Number of Family Managers	1.95	1.03	146.5***
Proportion Family Ownership	.98	.29	7,280.7***
Proportion Expecting Family Succession	0.56	0.22	101.5***

<sup>†</sup>  $p < .10$  \*  $p < .05$  \*\*  $p < .01$  \*\*\*  $p < .001$

**Control Variables.** Consistent with the work of Schulze et al. (2001, 2003) and others performing comparative studies (e.g., Watson, 2002), we controlled for industry, age, and size in our analysis. We included five categorical variables to measure the industry sectors in which the responding firms competed: RETAIL, SERVICE, MANUFACTURING, WHOLESALE, and CONSTRUCTION. Respondents were also permitted to check an “other” category that enabled us to measure the five primary industry categories without over-specification.

AGE was measured based on the number of years a business was in existence. We subtracted their stated dates of formation from the year 1999 to determine age. To adjust for skewness in the distribution of sales, the log of sales in 1998 was used to measure SIZE.

Although we used standard control variables in the study, due to the need to restrict the length of the questionnaire to achieve its primary purpose of studying the impact of the SBDC program, our list of control variables was not as extensive as desired. Although it is impossible to tell how a more extensive set of controls might have affected our results, we do note that aside from industry, age, and size, the studies conducted by Schulze et al. (2001, 2003) show that the additional controls were either insignificant or mixed in their impacts on economic performance.

### Exploratory Results

Descriptive statistics and correlations for the variables used in this study are provided in Table 2. We used an OLS multiple regression model to investigate our research questions. The results of the regression analysis are provided in Table 3. The proportion of variance explained is low but significant. The results are quite revealing with regard to the research questions.<sup>12</sup>

12. To ensure that the significance of the regression equation was not due solely to the control variables, hierarchical and step-wise regressions were run. The results of the former indicated that the independent variables of interest added significantly to the explanatory power of the regression. The results of the latter revealed that all of the statistically significant variables reported in Table 3 entered and remained in the equation during the step-wise procedure.

Table 2  
Descriptive Statistics and Correlations

	Mean	s.d.	Grow	Age	Retail	Service	Whole.	Mfg.	Const.	Size	Family	Plan	Board	FamPlan
Sales Growth	0.26	0.64												
Age	17.44	18.92	-0.188***											
Retail	0.20	0.40	0.014	0.000										
Service	0.16	0.37	0.043 <sup>†</sup>	-0.105***	-0.219***									
Wholesale	0.08	0.26	-0.047 <sup>†</sup>	0.054*	-0.141***	-0.126***								
Manufacturing	0.26	0.44	-0.091**	0.157***	-0.297***	-0.266***	-0.171***							
Construction	0.11	0.31	0.044 <sup>†</sup>	-0.082***	-0.171***	-0.099***	-0.153***	-0.208***						
Size (sales log)	13.65	1.27	-0.229***	0.322***	-0.022	-0.169***	0.066*	0.024	0.024					
Family Business	0.79	0.41	-0.081**	0.017	0.100***	-0.008	0.010	0.075**	-0.091**					
Strategic Planning	0.74	0.44	0.093**	-0.087**	-0.057*	0.032	-0.011	-0.013	-0.019	-0.075**				
Board of Directors/Advisors	0.75	0.44	0.005	0.056*	-0.083**	-0.042 <sup>†</sup>	0.037	0.094**	-0.001	0.116***	0.189***			
Family X Plan	0.57	0.50	-0.001	-0.066*	0.030	0.018	0.001	-0.054*	0.044 <sup>†</sup>	-0.085**	0.595***	0.683***	0.094**	
Family X Board	0.58	0.49	-0.060*	0.053*	-0.011	-0.030	0.055*	0.001	0.066*	0.023	0.608***	0.081**	0.682***	0.474***

<sup>†</sup>  $p < .10$  \*  $p < .05$  \*\*  $p < .01$  \*\*\*  $p < .001$

Note: Mean of 1998 sales revenues reported above is after log transformation. The actual sales mean was \$2.3 million in 1998 and \$2.6 million in 1999.

Table 3

Regression Results: Sales Growth as  
Dependent Variable

Independent Variables	Beta
Constant	1.536***
Age	-0.004***
Retail	0.019
Service	-0.019
Manufacturing	-0.067
Wholesale	-0.072
Construction	0.079
Size (log of 1998 Sales)	-0.100***
Family Business	0.074
Strategic Planning	0.287**
Board Directors/Advisors	0.085
Family X Strategic Planning	-0.223*
Family X Board	-0.069
<b>ADJUSTED R<sup>2</sup></b>	<b>0.081</b>
<b>F-STATISTIC</b>	<b>9.4***</b>

\* $p < .05$ , \*\* $p < .01$ , \*\*\* $p < .001$

The coefficient for FAMILY BUSINESS was not significant, suggesting that family involvement, independent of the effects of agency cost control mechanisms, creates no advantage or disadvantage for family firms. STRATEGIC PLANNING had a significant impact on performance ( $p < .01$ ). There was no significant relationship between BOARD and SALES GROWTH.<sup>13</sup> With regard to the interactions, FAMPLAN was significantly and negatively related to SALES GROWTH ( $p < .05$ ), which suggests that non-family businesses benefit more from strategic planning than family businesses. By contrast, FAMBOARD was not significantly related.<sup>14</sup> Among the control variables, both AGE and SIZE had significant, negative relationships with SALES GROWTH ( $p < .001$ ). None of the variables denoting industry were related to SALES GROWTH.

Thus, the results of our analysis suggest the following: (1) First effect: family involvement in the business, *independent of the effects of agency cost control mechanisms*, does not have an impact on performance, (2) Second effect: strategic planning enhances the performance of both types of firms, and (3) Third effect: non-family firms that conduct strategic planning appear to derive greater benefits from the process than family firms. Taken together, the findings suggest that there may be a net agency advantage to the family form of organization among small, privately held companies. The insignificant direct relationship between family involvement and performance suggests

13. Although the lack of a relationship between BOARD and SALES GROWTH was unexpected, the finding can be compared with that of Schulze et al. (2001) who found a *negative* relationship between family firm performance and the proportion of outsiders on the board.

14. In order to test the relationship between the board and sales growth with a finer grain measure, we also estimated the regression model using the size of the board and the number of non-family members on the board. These could be interpreted as reflections of the breadth of expertise represented on the board. Neither sensitivity analysis changed the results qualitatively.

that the major differences in performance among family and non-family firms may be a function of agency costs that the latter can control through strategic planning.

### **Agency Costs in Small Privately Held Firms**

Since there may not be much share dispersion or separation of ownership and management in small privately held firms, before concluding this article it is legitimate to discuss the sources of any agency costs in such firms and how strategic planning and a board of directors or advisors can be effective in controlling them.

First, the agency costs related to owner-lender conflicts of interest are likely to be important. The payoff to lenders from servicing small business accounts does not justify spending large amounts of time analyzing and monitoring their activities. Furthermore, because the survival and profitability of a small firm are dependent on the decisions and actions of a small number of owners and managers, the impact of any opportunistic behavior by those individuals will be proportionately higher. These agency costs are controllable through strategic planning (which may be more of a business plan in some small firms) because there would be better communication and an explicit plan against which the lender can evaluate the firm's performance. Consequently, most banks require a strategic business plan before they will lend money to a small firm. In addition, the presence of a board of directors or advisors provides an additional opportunity for lender control, particularly if a member of the bank gains a seat.

Second, agency costs can arise from owner-employee relationships, even if there is no manager to whom the owner has delegated strategic and/or tactical decisions. A lack of commitment of an employee in a small firm can, for example, result in poor record keeping that, in turn, leads to ineffective performance monitoring. Furthermore, the possibility of theft and other forms of opportunistic behavior are rife in small firms, which have fewer formal control mechanisms than large firms (cf. Scott, 1971). A board requires regular performance reports and can correct such problems before they become major. Although strategic planning will not necessarily prevent opportunistic behavior, it does provide a basis for control because it formalizes sales projections, cost estimates, and performance goals.

Finally, problems of altruism can result in agency costs for small firms. While the stakes may be smaller in size, the discretion of an owner-manager to misuse company expense accounts or permit shirking by family members will generally be greater. Strategic planning could limit such activities because an owner-manager will be able to appreciate more readily the costs and consequences of such behavior with regard to the viability of the business. Likewise, even boards of directors or advisors without formal power should act as a further check on altruism because of the influence their opinions will have on owner-manager behavior; all else equal, individuals tend to want the approval of their actions from friends and peers (Ajzen, 1991).

### **Conclusions**

In this article we addressed the question of whether family involvement mitigates, exacerbates, or creates agency problems. We pointed out that because family firms are likely to pursue both economic and non-economic goals, actions that are considered agency problems in non-family firms might not be so for family firms. As a result, there are unique measurement problems in studying agency costs of family firms. We addressed the various empirical issues and present a theoretical framework for studying the agency

costs of family firms through the impacts of agency cost control mechanisms. Finally, using the conceptual framework proposed, we present some exploratory results.

Our results suggest that, *excluding the effects of agency cost control mechanisms*, the family and non-family firms in our sample had similar economic performance as measured by short-term sales growth. They also show that strategic planning had a direct and positive impact on performance. More important, the results show that non-family firms gain more than family firms from at least one agency cost control mechanism—strategic planning. Thus, consistent with the arguments of various pioneering agency theory scholars, our findings suggest that family involvement may, indeed, decrease overall agency problems (Jensen & Meckling, 1976; Fama & Jensen, 1983).

## Caveats and Limitations

Our exploratory results, while revealing, may have been at least partially a consequence of the characteristics of our sample and measurement techniques. The availability of data from the SBDC program allowed us access to a large population of firms. However, the nature of the clients served by the SBDC and the fact that we were constrained in the extent to which we could address the unique research questions posed in this study resulted in several limitations.

Thus, the firms examined were small, privately owned, and still relatively young. The relationships for larger, older, and more complex publicly owned firms may be different. As family firms grow, we would expect traditional agency problems to become more severe because of greater dependence on non-family managers deprived of either economic or emotional stakes in ownership. In addition, the influences of altruism may be different when the stakes are lower, as in the case of the small firms we studied, compared to when the stakes are higher, as would be the case for larger firms such as those examined by Schulze et al. (2001, 2003).

The data were collected from a unique population of small firms that may not be representative of family or non-family firms in general (Storey, 2000). This problem is partially ameliorated by the fact that the population used is homogeneous and identifiable. However, future studies should endeavor to test agency relationships in family versus non-family firms using other samples that are perhaps more representative of the population of small firms in the United States, as well as other parts of the world.

We measured agency cost control mechanisms by two-level categorical variables indicating presence or absence. While our coarse grain measures are consistent with those used in other studies of agency costs in private firms (e.g., Durand & Vargas, 2003), tests of the effectiveness of the mechanisms used to control agency costs might be sensitive to the extent to which, and the acumen with which, firms utilize these mechanisms. For example, the comprehensiveness of a strategic plan and the process used to derive it may differ within and between family and non-family firms and this could affect the resulting performance benefits. Likewise, the functions, expertise, and experience of the board of directors or advisors could be important. While our results were not sensitive to board size or non-family management involvement, given the theoretical reasons for using boards in studies of agency costs, the measurement of this variable needs particular improvement in the future.

Our analysis could not differentiate among the sources of agency costs because we did not have separate scales for the different sources. While this limitation is shared by previous studies (e.g., Schulze et al., 2001, 2003), we think it likely that the agency problems and costs of family and non-family firms will vary by source. Future research is needed in this area.

Finally, performance is measured in purely economic terms as one-year sales growth. Schulze et al. (2001) also use sales growth, albeit over a longer time frame, in their study of agency costs in family firms, arguing that it is a more reliable measure of the performance of privately held firms. However, profitability may still be more appropriate for investigating the impact of agency costs on firm performance. Moreover, multiple performance measures, particularly some that accounted for non-economic goals, would have been desirable.

Despite these limitations our results are revealing because the sample contains both family and non-family firms, a feature not present in most previous research on agency costs in family firms. Moreover, we demonstrate how the three effects discussed are necessary to establish whether family or non-family firms have higher total agency costs. Finally, although focusing solely on economic performance is a limitation, our findings still make a contribution toward a partial theory of the determinants of economic performance in family firms.

### **Directions for Future Research**

Aside from extending the analysis of the research questions posed in this study to other sampling frames and improving upon the measurement of the key variables, there are several other promising directions for future research. For example, other research questions that remain to be answered include: What type of agency costs has the most detrimental impact on firm performance? What mechanisms work best to control different types of agency costs? Are agency costs the major barrier to business development in family, or non-family firms? Are agency costs more apparent in certain types of firms?

As noted above, family firms may also have goals other than economic performance that should be examined in future research. What are considered agency costs in non-family firms may not be so in family firms and vice versa. A complete examination of the impact of family involvement must take non-economic costs and benefits into account. For example, while altruism or other factors might yield positive short-term performance benefits to a family firm through a reduction in agency costs, there might be corresponding non-economic costs, some of which could have long-term economic consequences. If the self-sacrifices of family members become too great because of discrepancies in the degree of altruism among family members, perceptions of unfairness and the loss of the support and involvement of the most promising family members to other pursuits could ensue. Thus, altruism as a source of agency costs could help explain a number of non-economic behaviors commonly associated with family firms.

Another area where future research using agency theory would benefit is the study of management and ownership succession. When a family firm faces succession, agency problems may be heightened. Problems between the parent-owner, the progeny-successor, and other stakeholders may have nothing to do with altruism, but everything to do with traditional problems of moral hazard or adverse selection. Indeed, recent work by Miller, Steier, and Le Breton-Miller (2003) suggests the possibility of agency-related dysfunction occurring all too often during intra-family firm succession. At this transition stage in the life of a family firm, the relationships could be completely different from what we found in this study.

In conclusion, we do not consider our results definitive but rather suggestive of a set of relationships that are complex and potentially contingent on a number of factors, some of which may have not yet been identified, let alone measured. Of particular concern to us is the difficulty in measuring agency costs directly and in linking those costs with specific antecedents, remedies, and outcomes (Greenwood, 2003). Despite these problems,

it does appear that agency theory offers a rich and fruitful frame of reference by which the peculiar problems of family businesses might be studied. We hope that this article will stimulate further research and improvement in the concepts, measurements, and data collection methods used to study family firms. Our research, if nothing else, should call further attention to the importance of segregating the effects relevant to the research question and including non-family firms in comparative studies, with the accompanying task of carefully delineating family firms and comparing them with non-family firms in ways that best isolate the unique features of each.

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