Family Control and Firm Performance: Empirical Evidence from Sri Lankan Public Listed Companies

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Background, Issue and Purpose

Family business is a predominant form of business all around the world and, in most countries, family businesses account for a major share of business (See for e.g., La Porta, De-Silanes, Shleifer and Vishny (1998); Wiwattanakantang (1999); Anderson and Reeb (2003); Astrachan and Shanker (2003); Sharma (2004); Maury (2006)). According to Claessens and Fan (2002), in a typical Asian corporation one or several members of a family hold onto shares tightly. Being an emerging market economy in the Asian region, Sri Lanka too depicts a similar business structure. For instance, Senaratne and Gunaratne (2007) find that the ultimate controlling shareholder of the majority of the companies listed on the Colombo Stock Exchange (CSE) is an individual or a family, particularly a closely held company, and this indicates the prevalence of family ownership in Sri Lanka, mirroring that trend in other Asian countries (e.g. Clessens et al., 2000; Yammeesri, 2004) and in Western European countries as well (e.g. Faccio & Lang, 2002; La Porta et al., 1999). However, in Asian corporations, families achieve effective control of the companies in the group by means of stock pyramids and cross-shareholdings, a process which can be quite complicated in structure (Claessens and Fan, 2002). Despite the extensive use of these "control enhancing mechanisms" (Villalonga & Amit ,2009, p. 3048) that varies across Asian economies (Claessens & Fan, 2002), in Sri Lanka, 72% of the listed companies in the study of Senaratne and Gunaratne (2007) used these mechanisms as the means of achieving firm control. This suggests that the separation of ownership and control of Sri Lankan companies lies mainly between the controlling shareholders and the minority shareholders; hence studying "*businesses controlled by families*" rather than *businesses owned by families*" is relevant and appropriate in the context of Sri Lanka.

Due to the prevalence and significance of family businesses in the global economy (Anderson and Reeb, 2003; Morck and Yeung, 2004), acquiring a better understanding of the factors influencing their performance is important (Chrisman, Chua & Sharma, 2003). A growing body

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of literature has focused on the impact of family businesses on corporate financial performance (For instance, Anderson and Reeb, 2003; Ang, Cole and Lin, 2000; McConaughly, Walker, Henderson, Jr. and Mishra, 1998; Cronquvist and Nilsson, 2003; Maury, 2006; Villalonga and Amit, 2006 etc.), but the said literature on financial performance and family control has been divided and inconclusive to date. That is, a considerably large number of previous studies highlights the fact that Family - Controlled Businesses (FCBs) have concentrated ownership and/or voting rights and therefore they enhance firm performance (for instance, Anderson and Reeb,2003; Maury, 2006; Ang, Cole and Lin, 2000 etc.). Yet, the typical portrayal of a family firm suggests that these organizations suffer from capital restrictions, inter-organizational squabbles, executive entrenchment, and nepotism, all of which may detract from their performance (Allen and Panian, 1982; Chandler, 1990; Gomez-Meijaet al., 2003; Perez-Gonzalez, 2006; Schulze et al., 2001, 2003 as cited in Miller, Le Bretton-Miller, Lester & Cannella, 2007, p.2).Meanwhile, another stream of scholars find that no significant performance differences exist between FCBs and non-family controlled businesses (NFCBs), implying that family ownership and control are irrelevant for firm performance (for instance, Daily and Dalton, 1992; Miller et al, 2007).Hence, there is a controversy regarding the relationship between concentrated family ownership and control and firm [financial] performance (Jiang & Peng, 2011). In the meantime, it is obvious that there is no clear agreement amongst academics or practitioners as to what constitutes a FCB. Researchers like Miller et al., (2007) clearly explain that the findings of comparative studies on family businesses are highly sensitive to the way they are defined, and thus researchers like Mroczkowski and Teneweski (2007) make contributory efforts to delineating FCBs from Non Family Controlled Businesses (NFCBs) in the capital market context.

Notwithstanding the dominance of FCBs and their major contribution to the economy in diverse ways, there is no evidence to date of a published study on the performances of FCBs in Sri Lanka, to the best of the researcher’s knowledge. Against such a backdrop, and due to the dearth of research in this area, this study was designed primarily to examine the relationship between financial performances of listed FCBs relative to those of listed NFCBs in Sri Lanka. Subsequently, the study extended its scope by exploring the relationship between eight different categories of family control: Family Managed (FM), Family Identified (FI), Family Direct Managed (FDM), Family Indirect Managed (FIDM), Family Direct Identified (FDI), Family

Indirect Identified (FIDI), Young FCBs and Old FCBs, and their financial performances. This was in order to identify how different categories of family control perform under unique political, socio-cultural and business contexts in Sri Lanka, and their implications to agency costs. In working towards these objectives, it was essential to delineate FCBs from NFCBs due to two main reasons, as the literature suggests; 1) there is no clear consensus to date concerning the definition of FCBs and 2) findings of comparative studies on family businesses are highly sensitive to the way FCBs and NFCBs are defined.

Research Method

Collecting data on family control was an extremely difficult task in Sri Lanka; this was due to the control enhancing mechanisms that exist in public listed companies. This issue was further intensified by the scarcity of data available on firm ownership and control due to information asymmetries in listed companies in Sri Lanka. On the other hand, it was obvious that there was no clear agreement amongst academics or practitioners as to what constitutes a FCB. Based on the literature and Sri Lankan accounting standards, this study devised a framework to delineate FCBs from NFCBs in Sri Lanka, as a vital measure used to upgrade the validity of its findings. In addition, the study categorized family control into two main categories, namely, type of influence and modes of influence, resulting in eight different categories of family control. As all firm control and ownership data are qualitative in nature, quantification of them was done by converting them into dummy variables. Further, the study employed five main control variables called firm size, firm age, firm risk, industry clusters and time factor to enhance the overall validity of the model used in the study. Firm size was the natural log of the book value of total assets; firm age was the natural log of the number of years since the firm's inception and firm risk was the standard deviation of monthly stock returns. Six industry clusters were formulated from all 17 industries represented by the sample based on similar characteristics shared among them. Whether firm performance is influenced by pre and post war periods in the country, is the factor taken into consideration when incorporating the time variable into the model. Both industry clusters and time factors are treated as dummy variables in the study. Financial performance measures were basically two fold; accounting based measures and market based measures. Return on Assets (ROA) and the Return on Capital Employed (ROCE) were the two main accounting based measures, while Tobin's q was the market based measure.

The conceptual model developed in the study was empirically tested through a multivariate regression analysis done on 164 non- financial, non-public companies that have spread across 17 different sectors in the CSE during 2008 to 2011, yielding 437 firm-years or observations. The sample period was chosen based on the data availability; however, it represents both ups and downs in the market. The study employed considerable methodological rigor, ensuring appropriate levels of validity and reliability through means such as removing undue influences of outliers using ROCE as the category which shows the highest number of extreme values depicted by symbols outside the whiskers, taking all performance variables as ratios, and thereby removing even short-term shocks in time series data. Some control variables are included in the analysis in order to account for industry and firm specific characteristics and to minimize concerns about heterogeneity and endogeneity.

Results

Although the study formulated five hypotheses in order to find answers to three primary and two additional research questions, one is based on overall financial performance of FCBs when compared to NFCBs, and the other four are based on eight different types and modes of family controls. The findings of the multivariate analyses provide sufficient evidence to support H1 only in terms of ROA at the 5% significance level, H2 in terms of both ROA and ROCE at the corresponding 5% and 10% significance levels and to reject H3, H2a, H2b and other aspects relating to market based measures in H1 and H2 respectively.

Findings and Conclusion

The study supports partially two out of three main hypotheses developed, and the findings highlight the fact that family control is associated with higher accounting based performances, though the efficiency of using long- term funds appeared not to be very different when comparing FCBs and NFCBs. Active family control outperforms passive family control in terms of the results obtained from accounting based measures, but this fact has not been reflected in market valuations. Agency problem II appears to be more harmful to shareholder value and firm age is unrelated to financial performance. These results suggest that FCBs are effective business structures in Sri Lanka in terms of profitability, as they indicates lower agency costs incurred by ultimate owners and managers. Yet, family control gives rise to conflicts between the family and minority shareholders when shareholder protection is low and family control is high due to various control- enhancing mechanisms.

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