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Reflections on family firm goals and the assessment of performance

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A B S T R A C T

Assessments of family firm effectiveness depend critically on how goals and performance outputs are measured. Similarly, assessments of family firm efficiency depend critically on how performance outputs and resource inputs are measured. We illustrate this by showing that the assessment of performance is affected by how different family firm goal systems are specified. Gaining a better understanding of these fundamental concepts gives family business scholars the rare opportunity to set the rules of the game about how the performance of family firms, and other organizations that pursue the non-financial goals of a dominant stakeholder, should be assessed.

1. Introduction

One of the most frequently studied topics in family business research is family firm performance (Mazzi, 2011; Wagner, Block, Miller, & Schwens, 2015). Performance can be measured in terms of *organizational efficiency*, the relationship between outputs and inputs, or in terms of *organizational effectiveness*, the relationship between outputs and goals (Hofer & Schendel, 1978).[1] Most of the studies of family business performance conducted thus far focus on efficiency instead of effectiveness because they do not specify the goals to be achieved, the contexts within which the goals were to be achieved, and/or do not assess performance in terms of the extent to which the outcomes have achieved the goals.

Assessing performance as achievement of goals is important for both family and non-family firms, but it is even more critical for the family firms because of the multiplicity of goals they are explicitly or implicitly assumed to possess. For example, if a family has both financial and non-financial goals for the firm it owns, and one is achieved but the other is not, what is one to conclude about the firm's performance? If the family business research community is to reach a deeper understanding of family firm performance, there is a need for researchers to clarify their assumptions about the goals that family firms pursue and how outcomes can be compared with goals to assess performance.[2] Therefore, the purpose of this article is to discuss the implications and obstacles associated with assessing performance in terms of effectiveness (goal achievement) in family firms. However, because efficiency is more commonly measured and is also essential, we will digress where necessary to consider the measurement of efficiency in family business studies. We also note that survival is another indicator of firm performance but since it represents a minimum condition we shall treat it as a constraint that must be satisfied for goal achievement.

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[1] Goals can be defined in a variety of ways (Kotlar, De Massis, Wright & Frattini, 2018). In this article we view goals as measurable milestones sought by firm owners and managers in the continual pursuit of organizational purpose. As such, goals should be (1) linked to organizational purpose, (2) have an index for measurement (e.g., return on investment), (3) include a target to be achieved, which can include both minimum and aspirational levels of achievement, and (4) specify a time frame over which the goal should be achieved (Hofer & Schendel, 1978). We focus primarily on the index and target. We do not attempt to link goals with purpose or stipulate a specific time frame although we largely focus on long term goals and performance.

[2] This problem exists in most of the studies that have focused on efficiency because these studies have generally only measured financial outputs. By contrast, non-financial outputs and non-financial goals are both usually treated as independent variables, and rarely treated as dependent variables. Furthermore, the distinctions in the literature between the two concepts is not always clear. This confusion is both unfortunate and curious since non-financial goals and outcomes are sometimes considered to dominate financial goals and outcomes in family firms (e.g., Gomez-Mejia et al., 2007).

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2. The multiplicity of family firm goal systems

Both family and non-family firms pursue financial and non-financial goals. Financial goals can be expressed in terms of Financial Value Creation (Value Creation hereafter), which we define as revenues minus costs, including the cost of capital.[3] Scholars in economics and finance mainly deal with economic efficiency; but since they assume that regardless of time-period, the goal of firms is to maximize firm financial value, which is the accumulation of Value Creation over time, economic efficiency is essentially equivalent to effectiveness. However, management scholars have long recognized that bounded rationality makes maximization impossible and firms frequently satisfice by setting acceptable targets for firm performance over a specific time period (Cyert & March 1963; Simon, 1947). Management scholars also recognize that all firms have non-financial goals presumed to yield non-financial benefits for stakeholders (Cyert & March 1963). Furthermore, there appears to be a consensus among family business scholars that family firms may also pursue goals that yield family-oriented non-financial benefits (FONFB).[4] These goals are rarely, if ever, relevant for non-family firms but are considered of critical importance for family firms (Chrisman, Chua, Pearson & Barnett, 2012; Kotlar & De Massis, 2013).

There are many ways the goals pursued by family firms can be specified. Below are a few, far from collectively exhaustive, examples of the variations possible. We express these in symbolic form for more clarity and to make it easier to see the differences. Furthermore, to simplify the exposition, we shall ignore the non-financial goals and benefits that pertain to all firms so that we may focus on the interplay between Value Creation and FONFB, which is the crux of the differences between family and non-family firms as well as among heterogeneous family firms (Kotlar, Signori, De Massis & Vismara, 2017; Williams, Pieper, Kellermanns & Astrachan, 2018).[5] Finally, we assume that the ultimate goal of family firm owners is to optimize their utility, but that they will usually have goal targets or minimums believed to yield a satisfactory level of utility over a specific period, as well as face resource constraints that limit goal achievement.

2.1. Financial goal in terms of value creation ONLY

GOAL: Optimize Total $U = U_V$(Value Creation)
SUBJECT TO THE CONSTRAINTS:

- Value Creation Goal Target $\geq \Delta V^* \geq 0$
- R_V(Value Creation) $\leq$ Total resources available

Where $U_V(.)$ is the utility function for Value Creation; ΔV^* is the minimum level of Value Creation or change in value acceptable to the firm, which must not be negative to ensure long-term firm survival[6]; and $R_V(.)$ is the resource utilization function for the Value Creation achieved.

With this goal system, the firm pursues only Value Creation with available resources acting as the constraint to goal achievement. Consequently, this is the goal system assumed to dominate among non-family firms, notwithstanding our simplification from excluding the non-financial goals and private benefits relevant to both family and non-family firms.

As noted above, a basic assumption in economics, especially financial economics, is that firms pursue only financial goals except when altruism is explicitly included.[7] We express the goal system in the form of a utility function to accommodate the possibility that the controlling family's welfare or sense of well-being from goal achievement will not increase linearly with Value Creation for reasons such as risk aversion.[8] By using the term "optimize" instead of "maximize", we acknowledge bounded rationality. We also specify a minimum and aspirational level of goal achievement to reflect the fact that firms often specify a performance target that, if not attained, will trigger a search for alternative strategies to achieve the goal (Cyert & March 1963). Note that the goal system modeled allows resources used to be less than resources available to accommodate slack.[9] How resource constraints affect performance assessment will be discussed in the next section.

2.2. Business-first goal system

GOAL: Optimize Total $U = U_v$(Value Creation)

[3] Cost of capital is a complex concept dealt with more fully in books on financial economics such as Fama and Miller (1972). For our purposes, we argue that covering the cost of capital, which is the cost of equity when there is no debt, is necessary for Value Creation in the economic or financial sense since if satisfactory returns on invested capital are not achieved, the suppliers of capital will eventually want to withdraw their capital and will definitely not be willing to supply additional capital. Thus, we define cost of capital simply as the rate of return required to induce continued or new investments in an enterprise (e.g., Lambert, Leuz, & Verrecchia, 2007). By so doing, we subscribe to the theory of financial value where the cost of capital is set objectively by the capital market. The most important point in the financial theory of capital markets is that, although cost of capital is determined by the riskiness of the cash flows, it is not the total risk but the non-diversifiable systematic risk that is priced. It means that the total risk to which the controlling family is exposed does not have a simple direct relationship with the cost of capital for a family firm's cash flows, especially if the risk is highly diversifiable. It also means that if the capital market values only financial benefits while owners of the family firm value both financial and non-financial benefits, the price that the financial market would be willing to pay for family firms may differ from the price at which the controlling family would be willing to sell (See Zellweger et al., 2012). This does not, however, mean that the cost of capital, although determined by the capital market, is not affected by the presence of family firms. See Osakwe, Chua, and Chrisman (2011) and Chua and Schnabel (1986) about how together, the controlling family's non-traded control block, asymmetric information due to penchant for privacy, and non-financial benefits affect cost of capital through the capital market's simultaneous equilibriums in pricing information and risk. Thus, determining the cost of capital for family firms in an economy requires knowledge about the mix of industries, asset sizes, and controlling blocks held by family firms within that economy and how much information the controlling families tend to withhold from the capital market. The extent to which global capital markets are integrated becomes an issue because it determines the scope of the economy that must be considered. Although these are important considerations, we do not attempt to deal with them further as they are beyond the scope of our article, the purpose of which is to examine firm goals and firm performance in terms of goal achievement. Finally, we acknowledge that family firm owners may not always be concerned about the cost of capital in the short-run. For further insights the reader should consult Adams, Manners, and Astrachan (2004), Astrachan and Jaskiewicz (2008), and Zellweger and Astrachan (2008).

[4] Family-oriented non-financial benefits (FONFB) are of course closely related to the well-known concept of socioemotional wealth (SEW). We chose to focus on FONFB, however, because SEW is about stocks of affective endowments (Chua et al., 2015). By contrast, we are focusing on the measurement of goals and outputs of both the financial and non-financial varieties. Goals and outputs deal, respectively, with the flows of desired and actual financial and non-financial benefits accruing to families through the formulation and implementation of firm strategies. Therefore, FONFB which captures flows rather than stocks, better encapsulates the ideas we wish to express in this article even though our discussion applies to SEW as well.

[5] For the purpose of exposition, we also ignore financial goals that generate private benefits for managers and/or owners but do not increase Value Creation.

[6] We acknowledge that, in the short run, a firm does not have to be creating value to survive. In fact, in the short run, a firm can survive with negative accounting (or economic) profit so long as it has positive cash flows, or even negative cash flows so long as it can secure additional equity or debt capital through financing to meet short-term cash flow needs. But, in the long run, access to financial capital, even family financial capital, will vanish if there is no value creation. On another point, note that although we conceptualize Value Creation based upon economic and financial theories, our exposition of goal systems, including both the goals and the constraints, apply equally when using accounting profits or even cash flows as measures of Value Creation.

[7] Although economists are beginning to recognize that this assumption is not valid, most of their empirical work continues to be based on this assumption, perhaps because non-financial goals and outcomes are so difficult to model and measure.

[8] This is not the classical economics utility function based on stock but similar to the behavioral economics utility function such as the one used in prospect theory which is based on change or flow (e.g., Starmer, 2000). To measure utilities as a stock we would use financial value and socioemotional wealth (SEW) instead of Value Creation and FONFB.

[9] Firms have many different types of resources that are difficult to combine into one variable, including human, social, and financial capital; intangible and tangible resources; tacit and explicit knowledge, short and long-term assets, etc. This simplification is for representational and expositional convenience.

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