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Family firms: should they hire an outside CFO?

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Introduction

In family firms, the managing responsibility is often at least partly handed to non-family managers. The integration of non-family managers in family firms can be seen both negatively and positively. On the one hand, their presence may create problems due to the separation of ownership and management. External managers may follow different objectives from the family and therefore not act in accordance with family goals. For instance, external managers are likely to have a shorter term view compared to family members who want to hand over the company to the next generation. Family members may focus on dividend payouts to provide them with liquidity whereas an external manager may be inclined to reinvest cash into the company. Conflicts between owner and manager in regard to the financial management of the company may follow. But external managers may bring in valuable external resources which the family cannot provide from within their ranks, such as industry-specific experience or function-specific experience, e.g. in the field of finance from working at financial institutions. We analyze the role of non-family managers in family firms using both of these perspectives.

The position of the Chief Financial Officer (CFO) is often the first key management position for which a non-family manager is hired. A possible explanation is the finance-specific knowledge required for this position and the lack of a family member with the required background. The CFO is responsible for creating a sustainable financial policy to safeguard the long-term existence and independence of the firm. Evidence shows a positive impact of non-family CFOs on operational performance (Caselli and Di Giuli, 2010) and on the use of sophisticated financial products (Caselli *et al.*, 2010; Filbeck and Lee, 2000). Our aim is to understand other motives for hiring non-family CFOs in family firms.

We use the results of a survey of family firm owners in German privately-held companies. The survey included questions on the goals of the family, the members of the management board and the members of the advisory board. We wanted to capture the aggregate objectives of all family members so we specifically linked the question on the family goals to overall family goals rather than personal goals. Participants were asked about the importance of various goals: independence and control, enterprise value growth, low financial risk, financial flexibility, family succession and social responsibility. Based on a nine point Likert scale, we surveyed the importance of these goals for the family (1 = highly irrelevant, 9 = highly relevant) to detect nuances and higher variances in the replies.

Using the Hoppenstedt database and the member list of AlphaZirkel, an association of family firms in Germany, we collected a list of German family firms. We sent out the questionnaire to the family firm owner and followed up four weeks later via telephone to increase the response rate. In total, we used a sample of 195 questionnaires, which represented a response rate of 11 percent.

Non-family managers in family firms

Managers who are not owners of a company can be seen as agents who work for the company owners. The manager's own interest is not necessarily in line with the objectives of the owner of the company. Due to the lack of family ties, non-family managers are not emotionally bound to the company (Chua *et al.*, 2003). When a non-family CFO joins the family firm, it can be assumed that family-specific goals become less important in the financial management of the firm. The family loses part of its control over the company as the external CFO takes over responsibilities and may have different objectives from, the family (Gallo and Vilaseca, 1998).

The interplay of family and business in a family firm leads to a unique bundle of material and immaterial resources referred to as the familiness (Habbershon and Williams, 1999). The familiness can lead to strategic advantages (distinctive familiness) and disadvantages (constrictive familiness) depending on the individual setup of the business (Habbershon *et al.*, 2003). For instance, family firms often face a deficit in human resources because they tend to hire family members for higher ranked management positions even if they are not sufficiently qualified. In addition, non-family managers may view family firms as an unattractive option because they see limited potential to progress in the company.

Heterogeneity in the capabilities of the managers from different types of backgrounds and experiences can lead to well-informed and balanced decision-making. Hence, it can lead to competitive advantage if the family firm increases its human resources both in quality and heterogeneity through employing non-family managers. In particular, financial knowledge is often scarce in family firms if they have not built any specialized experience outside of their family firm or outside their industry. The employment of an external CFO can therefore be a valuable addition to the human resources of a family firm.

These two perspectives exemplify the dichotomy for family firm owners in hiring external managers. On the one hand, external managers imply a loss of control and lead to an increasing need for monitoring. On the other hand, external managers can be a valuable extension to the pool of human resources in a family firm. We shed light on this dichotomy by analyzing relationships between goals of the family firm owners and the employment of non-family CFOs.

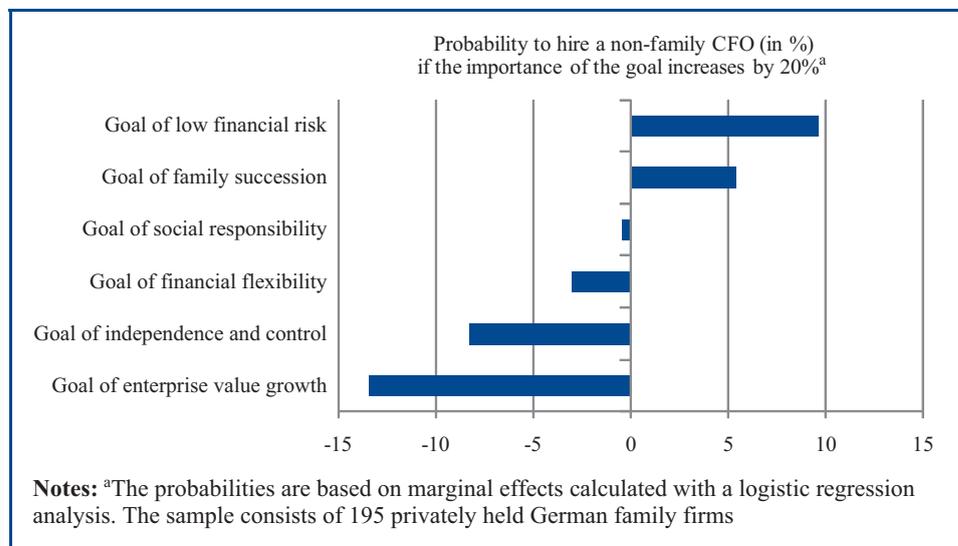
The decision to hire a non-family CFO

The goals of family firm owners determine the strategic management of the company and allow managers to be monitored against reaching the target. The interplay between the construct family and the construct business leads to complex goal structures. We analyze whether these goals are relevant to the decision to hire a non-family CFO. Based on the survey of 195 German privately-held family firms, we estimate the influence of six different family-specific goals on the likelihood of hiring an external CFO. We include the following goals in our analysis: independence and control, enterprise value growth, low financial risk, financial flexibility, family succession and social responsibility. We use logistic regression analysis to estimate how the probability of employing an external CFO changes if the importance of these family-specific goals increases by 20 percent. Figure 1 gives an overview of our results.

Family firms reflect a strong influence of the family on the strategic and often also the operational management of the firm. Privately-held family firms are usually under less pressure for short term performance compared to publicly-held companies, which allows

“The integration of non-family managers in family firms can be seen both negatively and positively.”

Figure 1 Influence of family goals on hiring a non-family CFO



them to follow longer-term strategies. Family firm owners usually have lower disclosure requirements and often operate without any significant external influence. The goal of independence and control is usually important for family firm owners to safeguard their influence in the company. The entrance of an external CFO can potentially threaten the goal of independence and control.

Our survey shows that the family-specific goal of independence and control is indeed negatively associated with the employment of a non-family CFO. The probability of hiring an external CFO decreases by eight percent when the goal of independence and control increases by 20 percent. Family firm owners with a focus on having full control over the firm shy away from hiring an external CFO. However, according to our survey the goal of independence and control is less important for hiring a non-family CFO than the goal of enterprise value growth and the goal of low financial risk.

An important goal of family firm owners is enterprise value growth, which can be relevant for the decision to hire an external CFO. Non-family CFOs are only bound to the company temporarily through their employment and, hence, they are probably focused on a shorter time frame in their financial decisions. In contrast, family members want to keep control over the company in the long term and, in addition, they are emotionally attached to the business. Therefore, a family CFO is likely to initiate longer term financing and investing strategies to foster sustainable company growth. In contrast, a non-family CFO may show less interest in long-term enterprise value growth and, hence, family firm owners would be reluctant to hire an external CFO.

In our survey, we find that the goal of enterprise value growth is negatively associated with the employment of an external CFO. A 20 percent increase in the importance of the goal of enterprise value growth is accompanied by a 13 percent decrease in the likelihood of employing a non-family CFO. The goal of enterprise value growth overall has the strongest impact on the hiring decision. Family firm owners seem to distrust external managers to have the same perspective on long-term company growth. It can be expected that non-family CFOs will have a shorter time horizon compared to the family who wants to hand over the company to the next generation.

Another important goal of the family is low financial risk because a large share of their personal wealth is usually bound up in the company. A diverse management team with managers of different backgrounds and experiences can bring in valuable resources to the company. The employment of a non-family CFO can lead to reduced dependence of the company on the family, which can decrease the overall financial risk. Family firms with an

external CFO show improved financial performance compared to other family firms (Caselli and Di Giuli, 2010), which can be partly explained by the special knowledge of non-family CFOs in the field of finance. For family CFOs, it was potentially not only their abilities, which led to their employment, but also their family status. Family firm owners may realize that an external CFO may bring in valuable additional resources required to lower the financial risk.

According to our survey, the goal of low financial risk has a significantly positive influence on the employment of a non-family CFO. A 20 percent increase in the importance of this goal is accompanied by an increase of 10 percent in the probability to hire an external CFO. It seems that family firm owners realize that an external CFO offers additional resources, which can reduce their financial risk. The goal of low financial risk has the second highest impact on the probability of employing a non-family CFO.

The company can enable the family to be financially flexible. The family is often dependent on the company to provide them with liquidity because a high proportion of their capital is normally invested in the firm. The employment of an external manager can lead to problems if the family goals are not in line with the goal of the external manager. It is possible that the objectives of the non-family CFO in terms of cash flow management may differ from the goals of the family. The family may want to receive dividends whereas the external manager may want to limit dividends in order to grow the company in the short term. The family may be less able to use the company as a flexible source of liquidity if a non-family CFO controls the financial management.

Our survey results show a negative relationship between the goal of financial flexibility and the probability of hiring an external CFO. Non-family CFOs are considered likely to decrease the financial flexibility of the family. However, the result is relatively weak. In our survey, we find that the probability of hiring a non-family CFO decreases by about three percent if the goal of financial flexibility increases in importance to the family by 20 percent.

Family succession is usually a highly ranked objective of family firm owners. The actual succession process from one generation to the next is an important goal (Le Breton-Miller *et al.*, 2004). External parties such as external non-executive board members or consultants can bring in their experience and a neutral opinion on sensitive issues. However, many family firms do not have non-executive board members and shy away from consultants. In this case, a non-family manager can be a stabilizing factor in the critical phase of succession by moderating between the generations. It can be helpful to have continuity in the important position of the CFO throughout the succession process. This can be particularly relevant if the family knows it will not have an overlap of family managers from different generations working jointly in the family firm. The age difference between the family members can for instance be too large or there could be a generation without an appropriate successor.

For the goal of family succession, we find a weak positive relationship with the probability of hiring an external CFO. The probability of employing a non-family CFO increases by five percent if the goal of family succession increases by 20 percent. Family firm owners see the advantages of having an external CFO in the process of succession. A non-family CFO can bring in an external perspective and can lead to continuity in the management in the transition period from one generation to the next.

For family firm owners, social responsibility in the community may be an important goal. This includes social activities, which go beyond the initiatives required by law. Recent studies

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have shown that family firm owners show a higher commitment toward their employees compared to non-family firms (Stavrou *et al.*, 2007). Family firm owners often stress that it is important for them to provide their work force with long-term employment and to support them by ensuring a pleasant work environment. This can be explained by the long-term orientation of family firm owners and the importance of the family having a good reputation in the community, particularly when the company bears the family name (Dyer and Whetten, 2006). An external CFO who is not emotionally bound to the company may not consider social responsibility as important as the family members. This may manifest itself in financing and investing strategies. Family firm owners who rank the goal of social responsibility highly may therefore be reluctant to hire a non-family CFO.

For the goal of social responsibility, we find only a very weak negative relationship with the probability of hiring a non-family CFO. The probability decreases by only 0.4 percent if the importance of the goal of social responsibility increases by 20 percent. An external CFO is likely to put less emphasize on creating a secure and pleasant work environment for employees than family firm owners. However, the influence of the CFO on strategies, which might affect the social responsibility is likely to be limited.

Conclusion

We analyze the decision to hire an external CFO in privately-held family firms. The role of external managers in family firms can be seen both negatively and positively. On the one hand, potential conflicts can arise by employing a non-family manager because he is likely to have different objectives than the family firm owner. On the other hand, hiring a non-family CFO may also bring in valuable additional human resources the family cannot supply from within their ranks.

We analyzed whether goals of family firm owners are related to the employment of an external CFO. We show that the goal of independence and control hinders family firm owners from employing an external CFO. They realize that a non-family member in this important position will decrease their influence on financial decisions. At the same time, they do not seem to trust non-family CFOs to act in line with their goal of enterprise value growth. Hence, family firms should carefully select an external manager for the position of a CFO. It can be helpful to establish trust prior to employment, e.g. through prior personal or professional ties to the candidate. In addition, family firm owners should focus on establishing incentives to align the objectives of external managers with their own interest of a long-term company development. This can be done through share option schemes or performance dependent pay.

We also find that family firm owners with a focus on lowering their financial risk turn to external managers as CFOs. Despite the loss of control, family firm owners realize that a non-family CFO can reduce their risk by adding valuable additional resources to the firm. Family firms with a management team consisting only of family members may therefore be able to create value through hiring an external manager.

Implications both for family firm owners and for potential recruits for a position as external CFO in family firms can be drawn from our analysis. First, family firm owners should realize that by giving away part of the control over their company, they can also gain additional

valuable input and potentially lower their financial risk through the employment of a non-family CFO. They need to select an appropriate external CFO and offer incentives for the manager to act in accordance to their goal of enterprise value growth. Candidates for the role of an external CFO can use our results to anticipate relevant decision factors for the family in the recruiting process.

Keywords:

Corporate governance,
Family firms,
CFO,
Non-family managers

An external CEO could have a substantial impact on the decision to hire an external CFO. Further, the relationship between a family CEO and a non-family CFO is likely to be important for the influence of the external manager on the financial policies. Further studies should analyze the relationships between different managers in family firms to further understand the long-term impact of a non-family CFO.

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