CHAPTER II

THEORETICAL BACKGROUND AND PREVIOUS RESEARCH

A. Theoretical Background

1. Family Business

Agency theory describes those shareholders as the principal and management as the agent. Management is the side that contracted by the shareholders to work for shareholders' sake. Management has the power to make a decision for the best sake of the shareholders. Therefore, management has to responsible every effort that they have done to the shareholders. Inside here, between the management and the shareholders, there will be a lot of conflict of each interest. But if the shareholders and the member of managements are from the family members, it will reduce the agency problem, which is the internal conflict. If the problems inside the company is reduced, and when the firms managed by the founding family, it will results a greater value and operated more efficiently. That is why the researcher wants to know the difference between family firm and non-family firm, whether it has a significant difference on each performance.

In family business' characteristics the discussion is about main characteristics of family business. Generally, the characteristics of family business ere: high involvement of family member in business means the policy and decision making, strategic planning and daily activities in company will be operated by family member. The focus is in control and participation of family member in business. This characteristic is strengthened by Harris, Martinez and Ward (1994) that in family firms, the owner is likely to be influence every step of the process. Other characteristics of family business are learning and sharing environment within the organization is high, it means sharing about business happens many times even in family gathering. High reliability and trust each other; family-hood management style; high sense of belonging from family member to the business and the last is less formal management and dual leadership.

Family businesses face some advantages and disadvantages. The advantages are in financial and organization culture field. For financial, the advantages are high rate independence of action; financial decision process is faster; possibility of such profit to use in the business expansion or business reinvestment. In organization culture the advantages are: the culture values will absorb faster; organizational culture is more solid; early understanding about business from the family member, and the last is organization culture is more flexible.

Disadvantages of family business are: family business sometimes becomes a confusing organization; have unfair reward system; and the difficulties to attract outsider professional. The other disadvantage of family business is the possibility of the rising of spoiled child syndrome or high tolerance for incompetent family member and the possibility to milk the business by the powerful family member for personal purpose. The other disadvantage is financial issue, such like: limitation to access the stock market.

According to John L. Ward (1987) the company is named as family business if two or more family member control the company's financial condition and the organization will be recognized as family business if there are at least two generations involved in the business and they influenced the organization's policy. From this point of view, family business means the business owned, controlled and operated by one or more family member. The business' relationship is very dynamic where business and family matter sometimes are mixture and blend in a chaos condition. For example, if one of the family members needs money then he will withdraw money from company without any clear reason or against the company rules. Other definition about family business is a business governed and/or managed on a sustainable, potentially cross-generation, basis shape and perhaps pursue the formal or implicit vision of the business held by members of the same family or a small number of families (Chua, Sharma and Chrisman; 1996).

As business in general, family business also has some advantages and disadvantage to face off. The advantages are in financial and organization culture field. The financial advantages are: the high rate independence of action, means, there is no stock market pressure; no take over risk and the profits belong to the family (no other party to share with). Therefore financial decision will be faster. Other benefit is the possibility of such profit to use in the business expansion or business reinvestment. The organization culture's advantages are: the culture will absorb faster. It is caused there is an intensive way in communicating the value and culture among the member of family, as at home and in office as well. In general, the family members involving in family business have the pride to their ancestor so that the organizational culture will be more solid. The other advantage of family business is an early understanding about business from the family member and the last is small and flexible bureaucracy. Ward (2004) states that the other advantage of business is the opportunity to cooperate with family member, high trust attitude among the family member, confirm the business and family position in the society, opportunity to make money, way to generate family values to children and to get some honor from society because providing a business and the last is to increase personal capability.

The theoretical literature often simply assumes that family firms are less efficient than corporations (e.g., Burkart et al., 2003, and Caselli and Gennaioli 2005). Yet, even from a pure theoretical point of view, family firms may have costs and benefits. Family control implies the costs of a concentrated ownership. First, families may use their control over companies to extract private benefits of control at the expense of minority shareholders.

The private benefit extraction may take different forms such as excessive compensation of family members or related-party transactions. Second, families may be excessively interested in maintaining control over the company even in the presence of a potentially valueincreasing acquirer. When the family owns less than 100% of the shares of the company, it gives an excessive weight to private benefits of control over security benefits. Another type of cost of family ownership has to do with the family itself and the ties among its members.

Berle and Means (1932) suggest that ownership concentration should have a positive effect on value because it alleviates the conflict of interests between owners and managers. On the other hand, Demsetz (1983) argues that ownership concentration is the endogenous outcome of profit-maximizing decisions by current and potential shareholders, so that as a result, it should have no effect on firm value. Demsetz and Lehn (1985), Himmelberg et al. (1999), and Demsetz and Villalonga (2001) provide evidence in support of Demsetz's arguments.

Family ownership is viewed as a governance form subject to demands of efficiency similar to those corresponding to other forms of ownership, Pollak (1985). The empirical predictions of the analysis are tested with data from a sample of Spanish family and non family firms listed on the Stock Market that survive as listed during all the period 1990 to 2004. The results confirm one of the main predictions of transaction costs theory, namely that in the equilibrium of assignment of transactions to governance forms, no differences in economic profits are expected among alternative forms of ownership.

Family ownership goes together with a strong preference for family control of the assets of the firm. To give up control implies a very high utility loss for the family up to the point that to keep control becomes an end in itself. In operational terms, the strong preference for control introduces a singular constraint in the choice set of family firms: total invested capital can not go beyond the amount that both, assures family control and assures appropriate diversification of total family wealth. In competitive product markets, the disadvantage created by the size-growth constraint would make impossible the survival of family firms with binding constraint, unless the preference for control that is behind the constraint is compensated with another advantage of family ownership. This advantage, if in fact exists, has to show up in the form of higher productive efficiency and it will be the net result of the transaction costs of contracting under family ownership. To our knowledge, the test of costs and benefits of family ownership in terms of growth constraint and higher total factor productivity is unknown in the literature.

Family firms listed on a Stock Market can deviate from the firm under "managerial control" described by Berle and Means, in that the former will have a dominant shareholder which, either will manage the firm or will keep close control over manager’s decisions. Since family firms are one particular case among firms with large shareholders, the costs and benefits of family ownership can be evaluated from the point of view of the cost and benefits of concentrated versus dispersed share ownership, Holderness (2003). But family owners differ from non family block holders in that the latter obtain only monetary benefits of control while family owners obtain also non pecuniary benefits, such as the amenities potential of Demsetz and Lehn (1985) and the satisfaction of transferring the firm to the descendants, Casson (1999). Non family block holders will sell the shares as long as the price compensates dividends and the monetary equivalent benefits of control. Family block holders, on the other hand, price so high the non pecuniary benefits that nobody else is willing to pay for them. In other words, family ownership implies that those that control the firm value such control very high and all the decisions are subordinated to hold enough shares/power to effectively control the strategic decisions without the interference of other external shareholders. the comparison of family and non family firms listed on the Stock Market is more suitable for the purpose of evaluating the comparative efficiency of ownership forms since listed firms issue shares to be held by minority non family shareholders.

2. Company's Performance by Financial Ratios

a. Liquidity Ratio

As the name suggests, short-term solvency ratios as a group are intended to provide information about a firm's liquidity, and these ratios are sometimes called liquidity measures. The primary concern is the firm's ability to pay its bills over the short run without undue stress.

1) Current ratio

The current ratio is calculated by dividing the current assts by the current liabilities. This ratio is used to indicate the capacity of business to meet short-term financial commitments. This is obtained by the generation of cash funds through the realisation of stock and debtors (accounts receivable) to pay current creditors (accounts payable) and other short-term liabilities. The higher the current ratio, the better the performance.

b. Financial Leverage Ratio

Long-term solvency ratios are intended to address the firm's long-run ability to meet its obligations, or, more generally, its financial leverage. These are sometimes called financial leverage ratios or just leverage ratios. The lower the financial leverage ratio is the better.

1) Debt to equity

The calculation of this ratio indicates the proportion of long-term debt to shareholders' funds.

2) Leverage ratio

Any ratio used to calculate the financial leverage of a company to get an idea of the company's methods of financing or to measure its ability to meet financial obligations. There are several different ratios, but the main factors looked at include debt, equity, assets and interest expenses. A ratio used to measure a company's mix of operating costs, giving an idea of how changes in output will affect operating income. Fixed and variable costs are the two types of operating costs; depending on the company and the industry, the mix will differ.

c. Turnover Ratio

The specific turnover ratios that discussed can all be interpreted as measures of turnover. What they are intended to describe is how efficiently or intensively a firm uses its assets to generate sales.

1) Inventory Turnover

This ratio measures the speed with which business can sell its average stock level. The calculation is made by dividing the cost of goods sold by the average stock levels held. This higher the result, the shorter the time stock is held awaiting sale. The average stocks are usually calculated by averaging the opening and closing stock for the period. As a substitute, total sales can be used instead of the cost of goods sold.

2) Asset turnover

The asset turnover ratio indicates the efficiency with which assets are used to generate sales. The calculation can be made using fixed or total assets.

d. Profitability Ratio

Profitability ratio intended to measure how efficiently the firm uses its assets and how efficiently the firm manages its operations. The focus in this group is on the bottom line, net income.

1) Gross Profit Margin

The gross profit is a result of the ‘mark-up’ on the cost of goods sold. It will be influenced by price changes with no change in costs, or by cost changes without a compensating changes in price. If a firm has a regular mark-up on all goods sold, the gross profit margin on sales should be constant. As a result, this ratio can be used as a control device to expose such things as excessive sales discounts or stock losses.

2) Operating Profit Margin

Operating profit for a certain period divided by revenues for that period. Operating profit margin indicates how effective a company is at controlling the costs and expenses associated with their normal business operations.

3) Net profit margin

The net profit after tax is shown as a percentage of sales. This calculation provides the ‘bottom line’ on sales and is useful in profit planning. The rate of net profit on sales indicates the efficiency with which operating costs are controlled, and is this a measure of management performance.

4) Return on investment

A performance measure used to evaluate the efficiency of an investment or to compare the efficiency of a number of different investments. To calculate ROI, the benefit (return) of an investment is divided by the cost of the investment; the result is expressed as a percentage or a ratio.

5) Return on equity

Equity represents assets less liabilities, or the net investment in the company by equity holders. It is calculated by dividing net profit after tax by equity.

e. Market Value Ratio

Market value ratio is based, in part, on information not necessarily contained in financial statements – the market price per share of the stock. Obviously, these measures can only be calculated directly for publicly traded companies.

1) Price to earnings (PE) ratio

Another ratio that is commonly used to measure performance is the price to earnings ratio, or PE ratio. This is calculated by dividing the market price per share by the earnings per share.

2) **Price book value ratio (PBV)**

The price/book value ratio is the ratio of the market value of equity to the book value of equity, i.e., the measure of shareholders' equity in the balance sheet.

B. Previous Research

The studies is given below are presented to give the reader a broader perspective on the subject. Anderson, Mansib, and Reeb (2002) stated that founding-family ownership reduces the cost of debt financing. Górriz and Fumás (2005) stated that The survival rate of family firms is higher than that corresponding to non family firms. Vilallonga and Amit (2004) stated, family firms have a mildly positive impact on value. Sciascia and Mazzola (2008) stated, family owned and family managed firm is associated with company performance, the relationship is positive.

Table 1
Previous Research

Researcher	Title	Variable	Method	Result
Ronald C. Anderson, Sattar A. Mansib, and David M. Reeb. (2002)	*"Founding Family Ownership and the Agency Cost of Debt."*	Market value, coupon, yield, credit ratings, duration, and maturity on nonprovisional bonds.	Linear regression	Founding-family ownership reduces the cost of debt financing. (Positive)
Carmen Galve Górriz, and Vincente Salas Fumás. (2005)	*"Family Ownership and Performance: the Net Effect of Productive Efficiency and Growth Constraints."*	Sales, ROA, assets, and total debt.	Regression	The survival rate of family firms is higher than that corresponding to non family firms. (Positive)
Belén Villalonga, and Raphael Amit. (2004)	*"How Do Family Ownership, Control, and Management Affect Firm Value?"*	Sales, assets, and market value.	OLS Regression	Family firms have a mildly positive impact on value. (Positive)
Salvatore Sciascia, and Pietro Mazzola. (2008)	*"Family Involvement in Ownership and Management: Exploring Nonlinear Effects on Performance"*	Sales, revenue, net profit, return on net asset, ROE, and dividends growth.	Regression	Family owned and family managed firm is associated with company performance, the relationship is positive. (Positive)

Source: Developed from Some Journals

C. Hypothesis Development

Based on theoretical background and previous research, hypothesis could be made:

Family owned firm and firm managed by the family which is PT. Gudang Garam Tbk. has positive impact to the company's performance rather than non-family firm (PT. Bentoel International) which is represented by the financial Ratio.