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Control Preference and Financial Attributes: Founders as CEOs in Small, Publicly Traded Firms

William R. Lane
Mel Jameson

Existing theories of the firm are silent with respect to cross-sectional differences in performance or characteristics of firms attributable to different types of managers. We hypothesize that the investment, financing and dividend decisions of founders differ systematically from those of nonfounder managers as a result of 1) founders valuing control more highly than do nonfounders, a condition we refer to as the control retention effect, and 2) founders being associated with younger, faster growing firms, a condition we label the life cycle effect. Our findings are that both effects are at work, but in different decision areas. No evidence is found that founders exploit their status to extract higher direct compensation.

I. INTRODUCTION

Financial analysis of the firm has traditionally been based on the neoclassical economic model of shareholder wealth maximization. More recently, agency theoretic models have recognized conflicts of interest, and the resulting interaction, between shareholders and managers. In neither model, however, is there room for differences in managerial behavior except in response to differing economic stimuli. Consequently, little attention has been given to cross-sectional differences in performance or characteristics of firms attributable to different types of managers. In this paper we investigate the proposition that one class of managers, founders, makes financial decisions that differ systematically from those of other managers. Specifically, we investigate the influence that founder status of the chief executive

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officer has on the firm's investing, financing, and dividend policy decisions. As a corollary, we also investigate whether founder status affects the CEO's direct compensation.

There is little empirical evidence of cross-sectional differences in firms being associated with managerial attributes. The extensive literature on takeovers as a disciplinary part of the managerial labor market, while implying that some managers are "better" than others with respect to shareholder wealth maximization, does not suggest a taxonomy of managers. Demsetz and Lehn [3] speculate that some managers seek to head media and sports firms because of the "amenity potential" of those industries, but they do not interpret their results as evidence that such industry preferences systematically alter the performance of those managers' firms. Holderness and Sheehan [9] find firms with a majority blockholder exhibit larger advertising expenditures than other firms, but are not different with respect to research and development expenses, capital expenditures or Tobin's q ratio. They also find no evidence that majority blockholders expropriate wealth. Holderness and Sheehan [9, p. 323, n. 11] suggest without elaboration that majority shareholders who are founders might have a different effect on firm performance than nonfounders holding majority blocks.

We hypothesize that founders systematically value control more highly than do nonfounders, and that this preference influences their decisions. We refer to this inclination as the control retention effect. One factor that could confound the control retention effect is that founders are also more likely to head younger, faster growing firms, a condition that is also likely to affect their choices. We label this influence as the life cycle effect. In our empirical work, we compare a sample of founder managed and nonfounder managed firms. We assume that the endogenous policy decisions of the firm are revealed in the firm's financial characteristics, and that those decisions reflect both the manager's individual preferences (i.e., the control retention effect) and the firm's exogenous investment opportunities (i.e., the life cycle effect).

The paper proceeds as follows. In the next section, we develop the two hypotheses in more detail, and examine the support for each in the literature. Section II focuses the analysis on areas in which decision making would be expected to differ under each of the hypotheses. From this basis, we define the specific variables we use to measure the various decisions and predict the effect of founder status on them under both hypotheses. In Section III we describe the sample and methodology. We report our empirical results in Section IV, and our conclusions in Section V.

II. FOUNDER STATUS AND FINANCIAL DECISIONS

A. The Control Retention Hypothesis

One possible difference between founders and other managers is in the degree of attachment to “their” enterprises. Several studies have shown that control is valued in the market. Meeker and Joy [17], Lease, McConnell, and Mikkelsen [15], Jarrell and Poulsen [11], and Partch [23] find evidence of this in the pricing of dual voting rights classes of stock. Similar evidence of the market value of control is reported by Walkling and Long [29] (among many others) in studies of the behavior of equity prices around acquisitions, and by Dodd and Warner [4] and Pound [25] in their studies of proxy fights. Holderness and Sheehan [9], while finding no evidence that majority shareholders expropriate wealth, cite the managerial involvement of majority shareholders as evidence of benefits to owning large blocks. Stulz [28] argues that the benefits of control of voting rights affects both the firm’s capital structure and the proportion of the firm’s equity held by insiders.

While some of the value placed on control undoubtedly stems from a desire to make value enhancing changes in operations, at least some of it seems to derive from a preference for control for its own sake. For owners of small businesses, there is direct evidence on this point. Galante [7] reports the results of a survey of owners of small businesses and finds “control” identified second only to “pride in product/service” as a source of satisfaction.

Beyond these indications that control matters in general, some literature suggests that founders, on average, hold even more tightly to control of “their” enterprise than do nonfounder managers. Morck, Shleifer, and Vishny [18, p. 106] write that founders “... might play a special role in the company ... because their attachment to the company is more than just financial.” Morck, Shleifer, and Vishny [19] cite founder status as a source of entrenchment, and report (among other findings) that founder status among the top officers adversely affects a measure of the firm’s performance. Elsewhere, Morck, Shleifer and Vishny [18, 20] present evidence that founders are less susceptible to removal by boards of directors or by hostile takeover than are other managers. That is, founders have found it possible or desirable to entrench themselves more firmly than nonfounding managers. Evidence consistent with founders using this stronger entrenchment in ways detrimental to the value of the firm is presented by Johnson et al. [13]. They report a significant positive response to the death of a senior corporate executive who is a founder, and a negative response for the

death of nonfounders.¹ Taken together with the evidence on entrenchment, this raises the possibility that founders' tighter control of their firms leads to different decision making behavior.

We refer to this explanation for differences between founders and other managers as the "control retention" hypothesis. Compared to other managers, founders bias any decision involving a tradeoff between managerial control and value maximization toward control retention.

B. The Life Cycle Hypothesis

Founder managed firms are likely to be younger firms than non-founder managed firms. The problems faced in the early phases of a firm's existence, and the managerial talents required to overcome them, differ from those faced in maturity. Holmes and Schmitz [10] present an economic model of optimal allocation of managerial resources, whereby those with a comparative advantage in entrepreneurship repeatedly found corporations and then turn operations over to those with more traditional managerial talents. In such a model, both the economic constraints faced by founder managed firms and the personality characteristics of their managers differ from those of nonfounder managed firms.

This idea is embodied in the notion of a "life-cycle" of a firm. The usual version of this product/firm life cycle identifies four phases: pioneering (or start-up), expansion (or growth), maturity, and decline. Cooper and Dunkelberg [2], consistent with Holmes and Schmitz [10], note that the different phases of the traditional life cycle require different managerial skills. We take the essential points of this exposition to be that newer firms 1) have a relatively richer set of growth opportunities, and 2) face relatively greater informational asymmetries in obtaining financing. The first of these observations can be interpreted to mean that firms in the early phases of the life cycle have a lower ratio of assets in place to growth options. Consistent with this picture, Evans [6] presents empirical evidence that firm growth decreases with age, holding size constant. Following the traditional terminology, we refer to this explanation for differences between founder managed and other firms as the "life cycle" hypothesis.

The two explanations we consider are not mutually exclusive and are not intended as competing hypotheses. Rather, they serve to motivate and organize our examination of founder managed firms. Both explanations indicate that factors not considered in static models of value maximizing firms or of manager-owner agency conflicts play a role in financial decision making. In particular, the control retention hypothesis postulates that different managers in identical economic circumstances behave differently

because of different attitudes toward the importance of control, and that these differences are correlated with founder status.

III. GENERAL EFFECTS UNDER THE TWO HYPOTHESES

In this section we examine the general impact of the control retention effect and the life cycle effect on financing, investment, and dividend decisions in order to identify those areas in which decision making would be expected to differ under each of the hypotheses.

A. Control Retention

We propose that the greater is the manager's preference for control, the more the managers shy away from choices that tend to dilute their control. Because managers are acting in their own self interests, however, the investment, financing, and dividend decisions are interrelated.

1. *Financing decisions.* Control preference leads managers to favor those forms of financing involving the least possible surrender of control to new security holders. Thus, internal financing is preferable to debt, which is preferable to equity financing. While this ordering follows Myers [21] "pecking order" theory of capital structure, the point is not to establish an absolute priority, but to predict differences in capital structure. Thus we predict managers with a greater degree of control preference use more internal financing, more debt and less equity than do other managers in identical situations. Consistent with this hypothesis, Amihud, Lev and Travlos [1] argue that the choice of financing method in acquisitions is motivated by the insiders' desire to retain control. Bidders with large insider holdings tend not to issue stock, but are more likely to issue cash.

The liquidity of the firm is affected by both the investment and financing decisions. Investment in liquid assets reduces the firm's risk of default, but also reduces the value of the equity and increases the likelihood of a takeover. Papaioannou, Strock, and Travlos [22] examine the situations under which the firm would likely carry excess liquidity (cash and securities as a proportion of total assets).² Because liquidity reduces risk, reduces future needs for external capital, and permits greater use of debt financing, we predict managers with a greater degree of control preference hold higher levels of liquidity than other managers.

2. *Investment decisions.* Managers with a strong preference for control will be less inclined to undertake investment projects to the extent that the

projects will require outside financing. Positive net present value projects are rejected when the value to the manager of the loss of control resulting from outside financing exceeds the value of their share of the project. Thus we expect control preference to be inversely related to capital expenditures.

Control retention also affects the investment in intangible assets, such as research and development and advertising expenditures. As with tangible investment, a reduction in these outlays decreases the need for external financing (i.e., increases internally available funds). Zeckhouser and Pound [30] and Jensen, Solberg, and Zorn [12] recognize another control retaining aspect of intangible investment. They argue intangible investment increases the cost (and thus decreases the amount) of external monitoring of the firm's management, which in turn decreases the supply of debt to the firm. As debt financing implies less loss of control than does external equity, and therefore is more desirable, we expect control preference to lead to lower than average levels of intangible investment.

In addition to predicting lower levels of investment, the control retention hypothesis predicts lower project risk. Managers are generally presumed to be more risk averse than wealth maximizing shareholders because a large portion of their wealth is firm-specific human capital. A preference for retaining control provides the manager with a further incentive to reduce firm-specific risk: the loss of the firm is the loss of a controlling position. Again, although there are countervailing arguments, we are interested in the comparative prediction that control preferring managers choose lower risk projects than does the general population of managers.³

3. *Dividend decisions.* The dividend decision is linked to both the investment decision and the financing decision. Smaller dividends mean more internal funds available for investment and less need for external financing.

According to Easterbrook [5], by paying fewer dividends, and by minimizing external financing, however, these firms would be less monitored than other firms, and have lower valuation (higher "agency" costs). Thus, in dividend policy, the manager desiring to retain control trades off the risk of loss of control through external financing against the risk of a disciplinary takeover. The greater is the manager's entrenchment and insulation from takeover, the lower dividend payment can be. Under the control retention hypothesis, dividend payout is inversely related to control preference.⁴

B. Life Cycle

This study assumes that, if the control retention hypothesis is valid, its effects should be observed among founder-managers. Since founders are,

by definition, the first managers of their firms, founder managed firms tend to be drawn from earlier phases of the life cycle. Thus we need to consider how this affects the predictions of the previous section. Characterizing firms in these early phases as having rich growth opportunities, but facing significant asymmetric information problems in financing, we discuss in this section the effect of the life cycle on observed financing, investment, and dividend decisions.

1. *Financing decisions.* Several authors have argued that the use of debt is negatively related to a firm's growth and positively related to its size.⁵ Firms in the earlier phases of the life cycle are generally smaller and faster growing than mature firms, and, by agency based arguments, are expected to use less financial leverage. To the extent that "young" firms also have relatively more intense asymmetric information problems, they have difficulty raising external funds, and make relatively greater use of internal sources of capital. Kim and Sorenson [14], among others, document a negative relation between growth and leverage; many studies have reported the positive correlation between leverage and size.

Papaioannou, Strock, and Travlos [22] note that liquidity is affected by the competitiveness of the firm's product market. In a highly competitive environment, as exists in the early phases of the life cycle, the firm is unable to earn positive economic rents. To survive, the firm either lowers product price or reinvests cash flows into positive NPV projects and intangible investments, rather than accumulate liquidity. Informational asymmetries are greater in these firms, raising the cost and reducing the availability of debt financing for those needs. Smaller liquid reserves result from the higher cost of debt financing for high growth firms.

2. *Investment decisions.* Given the relatively richer set of investment options, one expects firms in the early phases of the life cycle to exhibit higher (proportional) tangible investment. Intangible investment, especially research and development activity, indicates future growth opportunities. The availability of positive net present value projects precludes accumulating liquid assets.

Risk will be higher for firms in the early phases of the life cycle for two reasons. First, given the high degree of information asymmetry and the importance of growth options, young firms are likely to be perceived as being more risky by the market. Second, if founders are more entrepreneurial oriented as suggested by Holmes and Schmitz [10] and if this mindset involves a higher tolerance for risk, such firms should be riskier.

3. *Dividend decisions.* The theoretical effects of life cycle on dividends are not clear. On the one hand, dividend payouts should be small for young

firms. Their investment opportunities are a more valuable use of available funds than are dividends. Firms that rely on internal funds and reinvest earnings have less "free cash flow" to distribute as dividends. Simple observation shows growth stocks are traditionally low dividend stocks. On the other hand, growth options exacerbate informational asymmetry problems. Easterbrook [5] argues dividends reduce the resulting agency costs. Moreover, signalling models of the firm imply that dividend increases reveal management's expectations of higher future earnings. These asymmetric informational arguments suggest higher dividend payments for younger firms.⁶

C. Specific Variables

In this section we discuss the specific variables we use, and note the individual prediction generated by each effect.

1. *Financing decisions.* We measure the use of debt financing as the ratio of the book value of total assets to the book value of equity (*LEVERAGE*). The control retention hypothesis predicts that *LEVERAGE* will be higher in the founder sample; the life cycle hypothesis predicts it will be lower.

We measure liquidity with two variables, the current ratio (*CA/CL*) and the ratio of cash and short term investments to total assets (*CASH/TA*). As with *LEVERAGE*, the control retention hypothesis predicts higher values of the two liquidity measures in the founder managed sample; the life cycle hypothesis predicts lower values in the founder managed sample.

2. *Investment decisions.* We use two measures of tangible investment activity. Capital expenditure (*CAPEXP*) is the ratio of capital expenditures to total assets. The other measure of investment is based on the observation that the assets of rapidly growing firms are newer than those of firms investing more slowly. We measure average asset age (*ASSETAGE*) as the ratio of reported accumulated depreciation to depreciation expense. Since *CAPEXP* and the rate of growth of the firm (measured here by *G(EMPLOY)*, the three year compound annual rate of growth in employees) are positively associated with investment, the life cycle hypothesis predicts these values will be higher in the founder managed sample, while control retention predicts lower values. Because a larger value of *ASSETAGE* reflects slower, older investment, the opposite predictions are made for this variable.

We measure two aspects of intangible investment, advertising (*ADVERT*) and research and development (*R&D*). *ADVERT* is the ratio of advertising expense to sales, and *R&D* is the ratio of research and develop-

ment expense to sales. As was the case for tangible investment, the life cycle theory predicts higher values in the founder managed sample, while the control retention theory predicts lower values.

We measure firm specific risk (*CONVAR*) as the conditional variance calculated from estimating the single index market model with daily stock market returns. The control retention theory predicts founder managed firms will have lower risk while the life cycle theory predicts higher risk for them. We represent the market's perception of the risk-return tradeoff for the stock with the two coefficients estimated from the single index market model (*ALPHA* and *BETA*). As with *CONVAR*, the control retention theory associates lower values of *ALPHA* and *BETA* with founder managed firms, while the life cycle theory predicts higher values.

3. *Dividend decisions.* We use total dividend payout (*PAYOUT*) and common dividend yield (*DIVYIELD*) to measure dividend policy. The former is calculated as the three year average of the ratio of total dividends paid to income before extraordinary items, and the latter is calculated as the three year average of the ratio of common dividends paid to closing price at fiscal year end. The control retention theory predicts lower values of these variables for founder managed firms; the life cycle theory is ambiguous.

Table 1 provides a summary of the specific variables with the predicted effects of founder management under the two hypotheses.

IV. SAMPLE AND METHOD OF ANALYSIS

The sample is drawn from the "200 Best Small Companies in America", compiled in the November 14, 1988 issue of *Forbes*.⁷ The *Forbes* data includes information about the chief executive of each firm, including age, tenure with the firm, tenure as CEO, salary, percentage held of the firm's stock, and whether the CEO is the founder. To obtain values for the financial attributes, we also require the firm to be included in the Compustat annual industrial files and in either the *CRSP NYSE/AMEX* or *NASDAQ* daily returns files. All accounting variables are measured at the end of the 1986 fiscal year. The single index market model is estimated over the 200 trading days ending December 31, 1986. A total of 75 firms satisfy these constraints.

Managerial control may stem from sources other than the CEO's founder status or stockholdings. For each of the firms, we also examined *Standard and Poor's Stock Reports* to identify the percentage of stock held by officers and directors, family trusts, and other "allies." *Moody's* industrial

Table 1
 Predicted Sign under the Two Hypotheses
 of the Relation of Each Decision
 Variable to Founder Management

<i>Variable*</i>	<i>Control Retention</i>	<i>Life Cycle</i>
LEVERAGE	+	-
CA/CL	+	-
CASHTA	+	-
CAPEXP	-	+
G(EMPLOY)	-	+
ASSETAGE	+	-
ADVERT	-	+
R&D	-	+
CONVAR	-	+
ALPHA	-	+
BETA	-	+
PAYOUT	-	?
DIVYIELD	-	?

Notes: Definition and calculation of variables:

Tangible investment:

CAPEXP = Capital Expenditures / Total Assets.

ASSETAGE = Accumulated Depreciation / Depreciation Expense.

G(EMPLOY) = Three Year Compound Annual Rate Of Growth In Employees.

Intangible investment:

ADVERT = Advertising Expense / Sales.

R&D = Research and Development Expense/Sales.

Market perception of risk:

ALPHA = Intercept Term Estimated From The Single Index Market Model.

BETA = Market Coefficient Estimated From The Single Index Market Model.

CONVAR = Conditional Variance In Daily Returns From The Single Index Market Model.

Leverage:

LEVERAGE = Book Value Of Total Assets / Book Value Of Common Equity.

Liquidity:

CA/CL = Current Assets / Current Liabilities.

CASHTA = Cash And Short Term Investments / Total Assets.

Dividend policy:

PAYOUT = Three Year Average Of Total Dividends Paid/Income Before Extraordinary Items.

DIVYIELD = Three Year Average of Common Dividends Paid / Closing Price At Fiscal Year End.

manuals also were examined to identify which of the firms had dual classes of stock or had “poison pill” provisions.

The 75 firm sample contains 30 firms in which the chief executive is also the founder. Thirty-one two-digit *SIC* codes are represented in the sample. Although there does not appear to be any industry clustering in the overall sample, founder managed firms exhibit some clustering (10 of the 30 firms) into the non-financial service industries (primary *SIC* codes over 7000), compared to only four of the 45 nonfounder managed firms. To control for possible industry effects in the analyses, we create a service industry binary variable (one if the *SIC* code is 7000 or greater, zero otherwise).⁸

Table 2 presents the means for the variables of interest described above, and for other general attributes of the sample, broken down by founder status. The right-most two columns of the table displays the *t*-statistic and the associated “p-value” (the significance probability of *t*) for each variable for the test of differences between the means of the two groups. The growth rate, *G(EMPLOY)*, is measured as the three year compound annual rate of growth in employees.

Examination of the data reveal that the two samples differ in several respects. Looking first at the decision variables, we find that the sign for the differences in *ASSETAGE* is as predicted by the life cycle hypothesis, while those for *ADVERT*, *PAYOUT* and *DIVYIELD* behave as predicted by the control retention hypothesis. Differences between the two samples for the other variables are statistically not different from zero at the 0.10 level.

A comparison of the remaining variables indicates that the samples differ in other dimensions as well. The data reveal founders to be older, and to hold a greater percentage of the firm’s stock than nonfounders. Although founders have been CEOs longer than nonfounders, neither their total tenure with the firm nor their salary (which includes any bonus) is significantly different from that of nonfounders. Five of the firms headed by nonfounders have dual voting classes of stock, and two have poison pill provisions; founder managed firms are less likely to use these “entrenchment” methods. Both groups have sizable percentages of the common stock in the hands of allies: officers, directors, family trusts, and employee trusts. In seven of the founder managed firms, compared to five of the non-founder managed firms, more than 50% of the common shares is controlled by allies.

Founder managed firms are seen to be younger than nonfounder managed firms in that they are smaller, with (slightly) higher growth rates in sales and employees, and newer fixed assets, on average. For the three estimates from the single index market model (*ALPHA*, *BETA*, or *CONVAR*),

Table 2
Means of Various Characteristics of the Samples by Founder Status
of Chief Executive Officer with Test Statistics for Differences in
Means between the Two Samples

<i>Attribute</i>	<i>Founder as CEO (N=30)</i>	<i>Nonfounder as CEO (N=45)</i>	<i>t-statistic</i>	<i>p value for t</i>
A. Decision Variables				
LEVERAGE	1.642	1.648	0.051	0.960
CA/CL	4.378	3.200	1.829	0.075
CASHTA	0.249	0.204	1.030	0.307
CAPEXP	0.103	0.095	0.331	0.742
G(EMPLOY)	16.280	10.700	1.661	0.101
ASSETAGE	4.048	5.240	-2.156	0.034
ADVERT	0.009	0.024	-2.286	0.026
R&D	0.017	0.024	-0.906	0.378
PAYOUT	0.065	0.220	-4.612	0.000
DIVYIELD	0.005	0.014	-4.157	0.000
B. Market Model Coefficients				
CONVAR (x100)	0.108	0.048	1.670	0.105
ALPHA	0.001	0.001	-1.324	0.192
BETA	1.226	1.029	1.040	0.302
C. Other Firm Characteristics				
Sales (\$MM)	74.000	125.156	-3.040	0.003
Assets (\$MM)	69.533	102.578	-1.602	0.114
Shareholders (M)	1.648	1.871	-0.624	0.534
Sales Growth (%)	26.870	21.303	1.495	0.139
D. Chief Executive Officer Characteristics				
CEO's Age	58.9	53.6	2.806	0.006
Years with Company	22.7	19.9	1.106	0.272
Years as CEO	19.7	10.6	4.398	0.000
Salary (\$M)	304.2	341.5	-0.859	0.393
Ownership (%)	17.85	8.31	2.795	0.007
E. Other Control Entrenchment Characteristics				
Dual Classes	2	5	.	.
Poison Pills	0	2	.	.
Allies* % Owned	29.03	22.24	1.399	0.166
No. > 50% Owned	7	5	.	.

Note: * Management, insiders, and allies of management.

none of the differences between the two sample groups is statistically significant at the 0.10 level.

Because we want to isolate the effect of founder status as cleanly as possible, we report the results of cross-sectional regressions of the various decision variables on founder status (*FOUNDER*) and a collection of control

variables. Since we are interested in the effect of founder status on control retaining behavior, we include another measure of the degree of managerial control (*STOCK*). We also must control for measurable dimensions of the firm's life cycle. For this, we include two proxy measures for phase of the life cycle, $G(EMPLOY)$ and *SIZE*. Specifically, the regression analysis takes the form:

$$Y = B_0 + B_1*FOUNDER + B_2*STOCK + B_3*G(EMPLOY) + B_4*SIZE$$

Here, Y represents any of the nine decision variables or three market model measures. The right-hand variables control for the effects of founder status, manager ownership, and stage of the firm in the life cycle.⁹ We do not assume any structure other than that of the two hypotheses. We consider neither a system of simultaneous equations, nor any interaction terms. Our estimated models are the reduced forms of any such a system across the policy variables.

The regressor variable of most interest is *FOUNDER*, a binary (0,1) variable, which takes the value one if the CEO is the founder. The predictions of the previous section concern the sign on the coefficient of this variable resulting from control retention or life cycle considerations, as depicted in Table 1.

The extent of the CEO's ownership of the firm potentially reveals the CEO's desire to retain control. The greater the value placed on retaining control, the greater will be the CEO's stake in the firm. Manager ownership interest in the firm is measured by *STOCK*, the percentage of the firm's common owned by the CEO. Table 2 shows that founders own significantly more of their firm's common stock than do nonfounders in the sample. The variable *STOCK* is included to separate differences in control preference related to founder status from those associated with ownership structure.¹⁰

Life cycle effects are reflected in two variables, $G(EMPLOY)$ and *SIZE*. $G(EMPLOY)$ is a proxy for the growth aspects of life cycle, and equals the three year compound annual rate of growth in employees. The natural logarithm of annual sales is included as an independent variable, *SIZE*, to control for effects of differences in size. Table 2 indicates that the founder managed firms are significantly smaller than nonfounder managed firms in the sample, and have a numerically greater growth rate. The coefficients of both variables are evaluated in light of the predictions of the life cycle hypothesis.

The correlation coefficients for the four regressor variables are in Table 3. *FOUNDER* is significantly negatively correlated with *SIZE*, significantly positively correlated with *STOCK*, and weakly positively correlated

Table 3
Pearson Correlation Coefficients for the Four Independent Regressors with Significance Probabilities in Parentheses

	<i>STOCK</i>	<i>G(EMPLOY)</i>	<i>SIZE</i>
FOUNDER	0.330 (0.004)	0.191 (0.101)	-0.373 (0.001)
STOCK		0.016 (0.893)	0.058 (0.618)
G(EMPLOY)			-0.093 (0.426)

Notes: Definition and calculation of variables:

FOUNDER = 1 if the CEO is also a founder of the firm;
0 otherwise.

STOCK = the percentage of shares outstanding owned
by the CEO.

G(EMPLOY) = the 3-year compound annual growth rate in
employees.

SIZE = logarithm (ln) of sales.

with *G(EMPLOY)*, all consistent with founder management being associated with earlier stages of the firm's life cycle. All other correlation coefficients are not significant.

The final issue we consider is whether founders utilize their privileged position to extract greater direct compensation from the firm. The benefits to retaining control can be tangible, reflected in higher than average salary. We use the same estimating equation to examine the CEO's salary as a function of *FOUNDER*, *STOCK*, *G(EMPLOY)* and *SIZE*.

V. RESULTS

The results of the regressions are shown in Table 4. For each regression, the overall *F* statistic, its significance probability, and the adjusted r^2 for the regression are included, in addition to the estimates of the coefficients and the associated significance probabilities for the four regressors. The estimated regression coefficients are stable to addition or deletion among the regressors. As was the case in the simple comparison of the two samples, both control retention and life cycle effects are seen at work.

The regression for *LEVERAGE* is not very informative about the hypotheses, in that the overall regression is not significant. The estimated coefficient of *SIZE* is positive, a reasonable result since larger firms are expected to have relatively higher debt levels. The relation between insider

Table 4

Regression Results for Effects on Firm Attributes of Founder Status, Fraction of Shares Owned by the CEO, Employee Growth Rate, and Size.^a

$$\text{Model: } Y = B_0 + B_1*FOUNDER + B_2*STOCK + B_3*G(EMPLOY) + B_4*SIZE$$

<i>Dependent Variable</i>	B_0	B_1	B_2	B_3^b	B_4	F	r^2
LEVERAGE	-0.659 (0.562)	0.034 (0.794)	0.513 (0.208)	0.010 (0.980)	0.123 (0.050)	1.740 (0.151)	0.038
CA/CL	23.792 (0.000)	0.356 (0.564)	-1.404 (0.472)	2.567 (0.160)	-1.127 (0.000)	6.116 (0.000)	0.217
CASHTA	1.209 (0.007)	-0.025 (0.616)	0.137 (0.380)	0.273 (0.063)	-0.057 (0.019)	2.673 (0.039)	0.083
CAPEXP	-0.390 (0.059)	0.007 (0.754)	0.188 (0.012)	0.013 (0.844)	0.025 (0.025)	3.797 (0.008)	0.131
ASSETAGE	12.790 (0.034)	-1.412 (0.038)	3.199 (0.135)	-6.522 (0.002)	-0.387 (0.234)	4.727 (0.002)	0.168
ADVERT	0.005 (0.948)	-0.018 (0.054)	0.033 (0.260)	0.011 (0.692)	0.001 (0.854)	1.312 (0.274)	0.017
R&D	0.046 (0.540)	-0.007 (0.431)	-0.041 (0.132)	0.053 (0.038)	-0.001 (0.743)	2.125 (0.087)	0.057
CONVAR ^c	1.146 (0.000)	0.026 (0.431)	-0.017 (0.870)	-0.106 (0.274)	-0.059 (0.000)	5.201 (0.001)	0.185
ALPHA ^c	0.536 (0.076)	-0.068 (0.046)	0.084 (0.431)	0.062 (0.534)	-0.023 (0.162)	1.161 (0.336)	0.009
BETA	-3.916 (0.030)	0.288 (0.154)	-0.328 (0.605)	2.245 (0.000)	0.257 (0.009)	5.692 (0.000)	0.202
PAYOUT	-0.406 (0.289)	-0.090 (0.041)	-0.242 (0.079)	-0.283 (0.028)	0.037 (0.081)	7.066 (0.000)	0.247
DIVYLD ^c	-3.265 (0.191)	-0.518 (0.068)	-1.130 (0.206)	-2.458 (0.004)	0.274 (0.046)	7.589 (0.000)	0.263

Notes: ^a Numbers in parentheses are significance probabilities for the tests that $B_j = 0$ (for $j = 0, \dots, 4$), and that $F = 0$.

^b B_3 is $\times 10^2$

^c All coefficients are $\times 10^2$, except B_3 is $\times 10^4$.

ownership and leverage is not significant, a result contrary to that of Jensen, Solberg, and Zorn [12].

Similarly, in the regressions involving *CA/CL* and *CASHTA* only the coefficient of *SIZE* is significant. Liquidity is an inverse function of firm

size, inconsistent with the life cycle concept, but not evidence of control retention behavior. The significant coefficient for $G(EMPLOY)$ in the *CASHTA* regression is an industry effect, this coefficient becoming not significantly different from zero when the service industry variable is included. The somewhat greater liquidity of the founder manager sample indicated in Table 2 is apparently unrelated to founder status.

The variables measuring tangible investment generally respond to life cycle effects. In the regression involving capital expenditure, while the coefficient of *FOUNDER* is not significant, those for *STOCK* and *SIZE* are positive and significant. By construction, *STOCK* captures effects of the direct voting control of the manager. Thus its estimated coefficient is consistent with a Leland and Pyle signalling with insider ownership. The positive relation between *SIZE* and *CAPEXP* is inconsistent, however, with the presumption of the life cycle hypothesis that growth options decline with size.¹¹

In the regression on *ASSETAGE*, the coefficient of *FOUNDER* is significant and in the direction predicted by the life cycle hypothesis. Also consistent with the life cycle hypothesis, the coefficient of $G(EMPLOY)$ is negative and significant, indicating lower growth being associated with older assets.¹²

The results for the measures of intangible investment are inconclusive. In the regression for *ADVERT*, the regressors explain little of the variability in advertising expense. Nonetheless, the *FOUNDER* coefficient is significant and negative, indicating founder managed firms undertake relatively less of this form of intangible investment, weakly consistent with control retention behavior. In the regression for R&D, neither the coefficient of *FOUNDER* nor of *STOCK* is significant.¹³ The significant positive coefficient of $G(EMPLOY)$ is consistent with higher growth being associated with greater expenditures for research and development.

The estimates of the risk-return tradeoff from the market model are inconclusive. The *ALPHA* regression is not significant, although the coefficient for *FOUNDER* indicates the market penalizes founder managed firms, consistent with control retention. The coefficients on *SIZE* for the two risk measures are both significant, but with opposite signs.

The dividend policy variables most clearly reflect control retention behavior. Even after controlling for life cycle effects, the estimated coefficients of *FOUNDER* for both measures are significantly negative. Founder managed firms pay smaller dividends and have smaller dividend yields than other firms.

The regression estimates for the analysis of the CEO's salary are displayed in Table 5. After controlling for the firm's size and growth, and for

Table 5

Regression Results for Effects on Salary of Founder Status, Fraction of Shares Owned by the CEO, Employee Growth Rate, and Size.^a

Model: $Salary = B_0 + B_1*FOUNDER + B_2*STOCK + B_3*G(EMPLOY) + B_4*SIZE$

B_0	B_1	B_2	B_3^b	B_4	F	r^2
-1014.85	-11.05	239.13	0.559	72.28	4.037	0.141
(0.018)	(0.817)	(0.116)	(0.691)	(0.002)	(0.005)	

Notes: ^a Numbers in parentheses are significance probabilities for the tests that $B_j = 0$ (for $j = 0, \dots, 4$), and that $F = 0$.

^b B_3 is $\times 10^2$.

the CEO's stockholdings, we find no significant relation between founder status and *SALARY*. Therefore, with respect to direct compensation, there is no evidence of self-dealing behavior by the founders in this sample.

In summary, even controlling for insider ownership, the firm's rate of growth, and its size, we find some financial decisions are influenced by founder status. In the area of tangible investments, the life cycle effects seem dominant. Weak evidence of control retention is more found in the results for intangible investment activity. The greatest evidence of control retention is with dividends. Liquidity and firm-specific risk do not appear to be affected by either hypothesis.

VI. CONCLUSION

The findings of Morck, Shleifner, and Vishny [18, 19, 20], Johnson et al. [13], and others suggests founder status of the CEO adversely affects the value of the firm. We examine the effects of founder status on the financing, investment, and dividend policies of the firm to determine if founders' tighter control of their firms leads to different decision making behavior, or if the firms' stage in the life cycle dominates the decisions.

A comparison of samples of founder managed and nonfounder managed firms reveals differences in the financial behavior of the two sets of firms. These differences persist even after controlling for variables designed to measure the firm's stage in the "life cycle" and other factors. In some dimensions (notably tangible investment) the differences appear to reflect life cycle effects. To the extent that this occurs, founder status is still serving as a proxy for life cycle status. That is, the control variables do not completely capture the life cycle effects.

In other cases (dividends and advertising) the observed differences are consistent with the control retention hypothesis and not the life cycle hypothesis. We interpret this as evidence that, in at least some areas, there

are differences in managerial behavior more easily attributed to the manager's status as a founder than to exogenous economic circumstances. This evidence confirms suggestions in previous literature that such differences might exist. Moreover, our findings have consequences for theories of entrepreneurship, such as those proposed by Holmes and Schmitz, as well as for the financial analysis and management of founder run firms.

NOTES

1. This relation does not necessarily imply an inefficiency in founders' management. Shleifer and Vishny [26] propose there can exist manager-specific implicit contracts between the executive and employees, suppliers, customers, etc., the value of which is captured in the executive's compensation (defined to include entrenchment). If the executive dies in office, the firm gains the contracts, and thus their value; if the executive is fired, he/she retains the contracts. There is evidence, however, that the relation observed by Johnson et al. is not a founder effect, but is a result of the founder's usually large ownership stake. Slovin and Shuska [27] find the market's response to the death of an inside blockholder to be a function of the size of the block and independent of the deceased's founder status.
2. Their concern is with insider ownership. While finding no relation between liquidity and managerial ownership, they report liquidity is positively related to a Tobin's q ratio (their proxy for positive rents) and intangible investment (specialized resources and information), and negatively related to leverage and the length of the cash cycle (operating constraints).
3. Consistent with our prediction, Jensen, Solberg, and Zorn [12] extend their monitoring argument to firm specific risk and the financing decision. Decreasing the firm's business risk decreases the costs of monitoring management, and increases the availability of debt financing.
4. Under special circumstances, however, a founder's need to retain numerical control of voting rights can lead to an increase in dividend payouts. *The Wall Street Journal* (February 3, 1992, p. B7) reports that Turner Broadcasting System would pay its first dividend since 1975, most likely to provide funds for its founder's personal projects. The founder, Ted Turner, had been selling his stock for this purpose, but in the process had reduced his holdings to 56% of the voting control.
5. This literature is reviewed in Harris and Raviv [8].
6. Historical evidence can overshadow theoretical ambiguities. Pilotte [24], for recent example, uses dividend policy as an inverse proxy for growth opportunities, rejecting alternative interpretations of dividends as a proxy for informational asymmetry or liquidity.
7. These 200 firms are clearly not a random set, and drawing the sample from the "best" companies may create a selection bias. This sample, however, is appropriate for the structure of the analysis. The regressions assume that the CEO's desire to retain control affects his or her investment and financing decisions, and thus affects the financial characteristics of the firm. This structure is reasonable given the focus on founder status as the proxy for preference for control. An alternative argument (related to that of Leland and Pyle [16]), is that the firm's characteristics influence the CEO's desire to retain control and ownership status. It is easier to want to retain control of a successful

firm than an unsuccessful one. By sampling from a group of “best” firms, firms that are all successful, the likelihood of this alternative structural relationship is reduced.

8. We would have preferred a matching procedure to control for industry effects, but that is not feasible here. Founder CEOs are not distributed proportionately across industries, at least not in the *Forbes* data. A test of independence between one-digit *SIC* codes and founder status (one if founder, zero otherwise) has a chi-square of 13.427, with eight degrees of freedom, significant at the 0.10 level. When service industry classification is also reduced to a binary variable (1 if the *SIC* code is 7000 or greater, zero otherwise), the chi-square is 7.084, significant at the 0.01 level.
9. To determine the sensitivity of our results to industry effects, we repeat the analyses including the service industry binary variable as an independent variable. Except as noted, the results are unaffected by the inclusion of this variable.
10. All analyses are repeated redefining *STOCK* to include the percentage of the firm’s common owned by allies, including the CEO, in order to minimize the effects of limits to founder wealth, and to more closely measure the shares controlled by the manager. The results are unaffected by this variation, and are not reported. Table 2 indicates that while the ownership by allies is greater for the founder managed firms, the mean is not significantly different from that for the nonfounder managed firms in the sample.
11. One possible explanation recognizes that all these firms are small firms. Within small firms, a relatively larger firm may have an advantage in exploiting tangible growth opportunities.
12. When the stockholdings of allies are used instead of *STOCK*, the estimated coefficient on this variable becomes positive and significant, consistent with the control retention hypothesis. The coefficient of *FOUNDER* remains negative.
13. When the stockholdings of allies replace *STOCK*, the estimated coefficient on *R&D* is negative and significant, consistent with control retention.

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