

New Markets, New Products: The Unexplored Terrain of Family Businesses

Drake S. Mullens

Assistant Professor of Management, Tarleton State University, Stephenville, TX
e-mail: mullens@tarleton.edu

Abstract

This research investigates the relationship between family firms and size, family firms and product diversification, and family firms and geographical diversification. We find that family firms are negatively related to size and both product and geographic diversification. We proposed CEO educational attainment as attenuating the negative relationship between family firms and diversification, yet we fail to find significance for moderation in any of our models. Additionally, our results indicate the age of the firm is negatively related to product diversification.

Introduction

In recent years, there has been growing interest in family firms. Succession planning has been the primary focus in the family business literature (Zahra and Sharma, 2004). Yet a key issue, diversification of family firms, remains understudied. Diversification is one of the most heavily researched topics in the fields of strategic management, finance, and industrial organization (Datta, Rajagopalan, and Rasheed, 1991). The importance of diversification in the literature is well-established and evidenced by the vast number of studies on the topic. We find it particularly troublesome that family businesses have not been examined in the context of diversification since approximately 90 percent of all U.S. businesses are family businesses (Colli, 2003).

A criticism of family firms is they adopt a family first ethos wherein the family extracts resources from the firm for private consumption by the family (Reid and Adams, 2001). The rents extracted by the family can be detrimental to the growth, profitability, and survival of the family firm. Therefore, we first examine the size differential between family firms and non-family firms. Family firms are significantly smaller than their non-family counterparts. If the family CEOs were trained at the same level and at the same institutions as non-family CEOs, we believe the family firm will more closely resemble a non-family firm as managerial styles become increasingly similar with education. Thus, we argued that higher CEO education would attenuate the negative relationship between family firms and size. However, there is insufficient evidence to conclude that CEO education significantly moderates the relationship.

Next, we examined the relationship between geographical diversification and family firms. When we controlled for both the size of the firm, the number of full-time employees, and age of the firm, we found family firms are negatively related to geographical diversification. Family businesses conduct more business locally and in a smaller radius. We argued CEO education would attenuate the negative relationship between family business and geographical

diversification, yet the empirics did not support the argument. Finally, we examined the relationship between family firms and product diversification. Again, controlling for the size and the age of the business, we found family firms are negatively related to product diversification. On average, non-family firms receive significantly more of their total revenues from new products than do family firms. CEO education did not attenuate this relationship.

Theoretical Framework and Literature Review

Diversification

Since Gort (1962) and Chandler's (1962) pioneering studies, diversification has become increasingly important in the strategic management literature. Chandler (1962) suggested successful firms first diversified geographically, then integrated vertically, and concluded with product diversification. Since that time, management and finance scholars have amassed numerous theoretical and empirical contributions to the diversification literature. As stated by Datta, Rajagopalan, and Rasheed (1991), "The relationship between diversification and performance has been one of the most extensively researched areas in the disciplines of industrial organization, strategic management, and finance." Chatterjee and Wernerfelt (1991) noted, "Perhaps the research question that has attracted the most attention in the strategic management discipline is the possible association between firm diversification and performance."

Although there is considerable work on the relationship between diversification and performance, the results are inconclusive. The diversification literature can be broadly classified into two streams of research. The first stream of research examines the relationship between the degree of diversification and performance while the second stream can be characterized as the type of diversification. The second stream of research compares the performance consequences of related diversification with the performance consequences of unrelated diversification. In the first stream of research, the arguments propounding a positive relationship between degree of diversification and performance are based on market power (Datta, Rajagopalan, and Rasheed, 1991). Market power is thought to be associated with the possibility of cross-subsidization, predatory pricing and reciprocity in buying and selling (Markham, 1973). Clarke (1985) suggested diversification allows firms to move into more profitable markets. Other benefits are thought to arise out of synergies from complementary skills (Higgins and Schall, 1975) and Williamson (1975) and transaction cost economics argue diversified firms may be more profitable because they are able to deploy assets more efficiently. Gort (1962) failed to find a statistically significant relationship between degree of diversification and performance. Ravenscraft (1983) provided corroborative evidence suggesting the relationship is insignificant. However, Grant et al. (1988) and Rhoades, (1973) empirically demonstrated, in some cases, degree of diversification and can be positively related to performance. Yet, Amit and Livnat (1988), Imrl and Helmberger (1971), and Markham (1973) found a negative correlation between diversification and performance.

The arguments contending related diversification is associated with higher performance than unrelated diversification are rooted in resources and the transfer between business units. Related diversification can allow the exploitation and transfer of core factors between units which may lead to efficiencies in resource allocation, as well as the exploitation of technical and managerial expertise (Rumelt, 1982). Porter (1985) contributed the notion of interrelationships between divisions based on functional expertise leading to economic benefits. Rumelt (1974) pioneered the research in the second stream of research where he demonstrated related diversification is associated with higher performance than unrelated diversification. Rumelt,

(1982), Varadarajan (1986), Varadarajan and Ramanujam (1987), Jose Nichols, and Stevens (1986), Lubatkin and Rogers (1989), Ilinitch and Zeithaml (1995), and Silverman (1999) confirmed the relationship hypothesized and empirically demonstrated by Rumelt (1974). However, there are nearly as many studies that find the exact opposite—unrelated diversifiers outperform related diversifiers (Rajagopalan and Harrigan, 1986; Elgers and Clark, 1980).

Similar to the diversification and performance relationship, studies have examined the relationship between family firms and performance. Just as with family firms and diversification, the relationship between family businesses and performance is inconclusive. On one hand, there is an argument suggesting the unique combination of ownership and control present in a family business results in the exchange of profits for private rents by the family who controls the firm (Fama and Jensen, 1983). Demsetz (1983) contends that the owner control combination leads to nonpecuniary consumption and utilizes scarce resources in a way inconsistent with profit maximization and detracts from profitable investments. Shleifer and Vishny (1997) suggest the owner controllers seek to extract private benefits from the firm. On the other hand, there is at least some evidence to suggest family owned and controlled firms have some performance advantages over non-family firms (Daily and Dollinger, 1992). Daily and Dollinger (1992) asserted performance advantages arise in family firms from decreased monitoring costs and goal congruence. James (1999) argued the benefits accrue from extended investment horizons.

Chrisman, Chua, and Steier (2003) surveyed 190 family business articles published between 1996 and 2003. They found only 3% examined geographical diversification while no studies examined product diversification. Zahra and Sharma (2004) noted the same issues have dominated family business research, primarily succession planning, while key issues like diversification are routinely ignored or understudied. Colli (2003) suggested 90 percent of all businesses in the U.S. may be family firms. Additionally, Anderson and Reeb (2003) argued that roughly one-third of the largest U.S. companies were controlled by founding families. Shanker and Astrachan (1996) estimated approximately 20.3 of the 22 million US businesses are family-owned and controlled. With the importance of diversification, as evidenced by the commitment to the study thereof, it's particularly alarming that we, as researchers, have failed to examine and explain the diversification of 90% of businesses in the United States. Thus, because of the paucity of research on diversification in family firms, the goal of this study is to examine, explain, and empirically test the diversification behaviors of family firms.

Risk, Diversification, and Family Firms

Risk is often defined as the probability that the actual return on investment will deviate from the expected return (Van Horne, 1980). Leontiades (1986) argued diversification leads to improved economic performance, as measured by the variability in profitability. Amit and Livnat (1988) demonstrated that diversified firms had lower profits and high levels of diversification were associated with lower risks, measured by variability in cash flows. Grinyer et al. (1980) found no significant relationship between diversification and risk. Generally, the diversification literature has suggested unrelated diversification is associated with lower risks because of the potential to pool risks. Bettis and Hall (1982) and Montgomery and Singh (1984) failed to observe a significant relationship between unrelated diversification and the reduction of risk.

However, for small businesses, which are mostly family businesses, there are fewer opportunities to reduce risk through diversification (Everett and Watson, 1998). Small, family businesses rely on the management expertise of the family which cannot be easily scaled to

accommodate diversification; therefore, family firms do not have the ability to diversify without the employment of professional management (Hall, 1992). In addition, they may not have the resources to commit to diversification. Recall Fama and Jensen (1983), Demsetz, (1983), and Shleifer and Vishny (1997), amongst others, argued that the combination of ownership and control results in the extraction of both pecuniary and non-pecuniary resources from the family business in a way that is inconsistent with profit maximization. Thus, because resources are detracted from business uses by the family, family firms may simply have the inability to commit resources to diversification. Because of the scarcity of resources in family firms, committing resources to diversification may be characterized as a risk that threatens the very solvency of the family business. If the family firm were to begin to place reliance on debt to diversify, a door would be opened for the lender to monitor the family firm, thereby reducing the opportunity for the family members to extract quasi-rents.

Since diversification can be viewed as a risk to small, family businesses, it is important to consider the risk orientation of family businesses. Ward (1997) explored the reasons family business are risk averse. He noted that second generational leaders and beyond face many doubts and pressures. The leaders, beyond the first generation, may feel a need to show respect for their predecessors. Also, the decisions the leaders in the family business make will affect the welfare of the family since the value of the family business is closely related to the family's wealth. Thus, the fear of failure and the fear of disappointing the family results in risk aversion or a reluctance to take risks. In that same vein, first generational leaders of the family business have invested considerable financial resources in the business. Risk taking could lead to both financial ruin and personal ruin. Since a family may rely on the family business to survive, the leader may not want to jeopardize the welfare of the family. Further, financial ruins could unduly place strain on relationships within the family. Moreover, as the family leader grows in age, his or her personality will change, becoming increasingly more conservative and risk averse (Buckley, 1994). Initially, in the early stages of the firm's life, neither the family nor the firm may have adequate resources for diversification. As the firm and the founder of the firm ages, an increase in resources should develop, but the risk aversion also increases with the founder's age.

CEO Education as a Moderator

Hambrick and Mason (1984) noted education is instrumental in shaping individual's cognitive base. Similarly, Domhoff (1983) argued educational institutions transmit the mentality observed in top management teams. Students are exposed to particular vocabulary, beliefs, values, and ways of thinking. Additionally, intelligence has been demonstrated to be positively related to openness to experience. We argue that education will attenuate the negative relationship between family firms and diversification. In addition to the values transmitted through educational institutions, we believe that educated leaders of a family firm will more closely resemble, in action, leaders of professionally managed non-family firms. Because of that resemblance, we also believe educational attainment will attenuate the negative relationship between family firms and size.

Hypotheses

In small family firms, risk reduction through diversification may not be attainable. Fama and Jensen (1983), Demsetz, (1983), and Shleifer and Vishny (1997) contended the family who owned and controlled firms were able to extract private rents from the firm for personal use in such a way scarce resources, including capital, were not available to pursue investments. Because these firms may lack capital resources, irrespective of the families' consumption,

diversification may pose a risk to the firm and family. If already scarce monetary resources are utilized to diversify, either geographically or through products, the ability of the firm to remain solvent may be threatened. In addition, by definition, family firms rely on the small pool of management expertise of the family (Everett and Watson, 1998). In other words, the family does not have the ability to diversify because of their limited pool of human resources. Thus, Hall (1992) suggested family firms would need to employ professional managers to diversify. However, small, family firms are reluctant to hire professional management (Reid and Adams, 2001). Professional management reduces the control the family has in the firm and the reluctance to hire professional management is indicative of a “family first ethos as opposed to a business first ethos” (Reid and Adams, 2001).

As just discussed, the family may not have the necessary resources to commit to diversification; although, the family firm may increase their debt to gain resources. Mishra and McConaughy (1999) note family firm CEOs are averse to control risk, which suggests the CEOs are concerned with losing control of the firm. According to them, debt increases the likelihood of bankruptcy of the family firm, as well as decreases the ability of the family to extract private rents from the firm because of the debt-holders’ increased monitoring, both of which reduce control of the firm by the family. Moreover, The Arthur Anderson/MassMutual American Family Business Survey '97 found "Family Businesses tend to avoid debt." The survey found 34.3% of family firms reported no debt and 34.2% of the firms indicated debt to equity ranges from 1% to 25%. McConaughy (1994) demonstrated, publicly traded founding family controlled firms utilize significantly less debt than do publicly traded non-founding family controlled firms. Furthermore, Agrawal and Nagarajan (1990) recorded firms that had no long-term debt were positively related to family control. Therefore, these studies taken together, indicate that although family firms could generate resources necessary to diversify, family firms are debt averse and unlikely to take on debt, to diversify or otherwise. Because of the rent extraction by the family that detracts from profitable investments, the limited pool of managerial expertise held by the family, the debt aversion, and the family first ethos, I argue:

Hypothesis 1: Family firms will be smaller in size compared to non-family firms.

Hypothesis 1a: CEO educational attainment will attenuate the size differential between family firms and non-family firms.

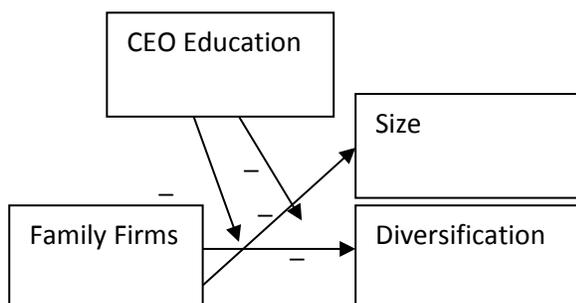
Hypothesis 2: Family firms will be associated with less geographic diversification than non-family firms.

Hypothesis 2a: CEO educational attainment will attenuate the negative relationship between family firms and geographic diversification.

Hypothesis 3: Family firms will be associated with less product diversification than non-family firms.

Hypothesis 3a: CEO educational attainment will attenuate the negative relationship between family firms and product diversification.

Full Model



The variables are explained in the following dependent and independent measures sections.

Methodology

Sample and Data Collection

In 2007, a random sample of 1976 businesses was drawn from a moderate sized city in the South Western United States. A mail survey was mailed to each on of the businesses included in the sample. 199 surveys were returned for a response rate of 10.1%.

Dependent Measures

Product diversification was assessed using a single item in which respondents were asked, “In the last two years, new products and services accounted for ____% of growth in sales revenue?”

To assess the size differential between family and non-family firms, we included total revenue as a dependent measure. For this, respondents were asked, “My company’s total annual revenues are?” with the following categories from which they could select: \$0-\$249,999, \$250,000-\$499,999, \$500,000-\$999,000, \$1,000,000-\$4,999,999, \$5,000,000-\$9,999,999, \$10,000,000-\$49,999,999, and \$50,000,000 or more.

For geographical diversification, the respondents were asked what percentage of business comes from 1) local, 2) DFW-area, 3) State-wide, 4) Regional, 5) National, and 6) International. A density measure was then created based on the distances in each of the available responses and percentages. We considered local to be a 15 mile radius, DFW 50 mile radius, state-wide 300 mile radius, regional 500 mile radius, national 1000 mile radius, and international 2000 mile radius. The measure was calculated by multiplying the miles by the respective percentages.

We used a non-traditional measure for performance of family firms. The primarily problem afflicting family businesses in the literature is the inability to grow. Therefore, we use two measures of size to assess performance of the family firm, number of employees and sales revenues.

Independent Measures

In our study, we have family firms and CEO education as independent variables. We have two measures to assess the degree to which the firms are family firms. The first is a simple dichotomous item that asked whether the firm is family business or not. The second item asks the percentage of managers who are family members.

CEO education was determined by asking, “My company’s CEO finished __High school __College __Graduate School.” For the interactive term, we simply multiplied CEO education by family.

Control variables

Firm age was determined by asking, “My company has been in business for _____ years?” We included firm age as a control variable since it has been consistently demonstrated to be positively related to both product and geographical diversification (Hoskisson and Hitt, 1990). As firms age, they will accumulate the necessary resources and experience to diversify (Hitt, Hoskisson, and Kim, 1997).

Firm size was assessed by the total number of full time employees. Again, the argument for the inclusion of firm size as a control variable relates to resources. As a firm increases in size, to reap economies of scale and scope, it may diversify across different geographic markets (Hoskisson and Hitt, 1990). Moreover, as firm size increases, investment in R&D expenditures increases. This will result in more product diversification, and additionally, the firm is more likely to diversify geographically and amortize the expenditures across more markets.

Results

	Model 1	Model 2	Model 3	Model 4	Model 5	Model 6
Family	1.848***	0.577	10491.890*	1626.414	17.657*	9.947
Age			90.267	79.489	-0.369*	-0.379*
Size			24.343	24.225	-0.008	-0.009
CEO Ed		-0.295		-6749.516		-6.039
CEO Ed x Family		0.505		3917.515		3.413
Observations	165	160	170	166	127	124
R-squared	0.186	0.210	0.044	0.041	0.041	0.040

* significant at 10%; ** significant at 5%; *** significant at 1%

Model 1

As hypothesized, family firms are, on average, 1.848 categories lower than their non-family firm counterparts at an alpha of .01. The exact difference in total revenues is difficult to quantify since there is not equal differentials in each of the categories.

Model 2

As indicated by the above results, family firms do not significantly interact with CEO education, at any reasonable alpha, when total revenue is considered as a dependent variable.

Model 3

At an alpha of .1, family firms are negatively related to geographical diversification, as predicted. The data were coded as 1 when a respondent indicated the firm was a family business and 2 when the person indicated it was not a family business. This suggests that on average, a non-family firm's geographical density is 10,491 higher than that of family firms. Neither of the controls variables, firm size or firm age, was significant in this model.

Model 4

This model examines CEO education as a moderator of family firm's relationship with geographical diversification. Interestingly, we observed that none of the variables in the model was significant. This is suggestive of a multicollinearity problem. We therefore examined the correlation matrix which is listed below. As observed in the correlation matrix, the interactive term is highly correlated with both family firms and CEO education. Therefore, it may act as a suppressor and marginalize the effects of family firms.

Model 5

In this model we examined the relationship between family firms and product diversification with firm age and firm size as control variables. As with geographical diversification, family firms are significant, at an alpha of .1, and negatively related to product diversification. The results indicate, on average, non-family firms have 17% more growth in their

sales from new products than family firms. Contrary to our initial belief, firm age is negatively and significantly related to product diversification at an alpha of .01. Alternative explanations of this will be examined in the discussion section.

Model 6

This model examines the interaction of family firms. Again, the interactive term is not significant at any of the conventional significance levels.

Discussion

In this paper, we sought to examine the diversification behaviors of family firms. Diversification is critically important to the strategic management literature, as evidenced by the association between firm diversification and performance being the most heavily researched relationship in the field of strategic management (Chatterjee and Wernerfelt, 1991). Despite the preoccupation with the diversification-performance relationship in strategic management Chrisman et al (2003) found only 3% of their 202 reviewed family business studies examined geographical diversification while they reported no studies that examined product diversification. Since family business comprise around 90% of all US businesses (Colli, 2003), an attempt to understand their relationship with diversification is warranted. Specifically, we argue family firms will be negatively associated with firm size because the family extracts private rents from the firm, they are associated with a family first, as opposed to business first, ethos, and they are reluctant to hire professional managers and take on debt because of their aversion to control risk. Hypothesis one, which argued family firms were negatively related to size, as measured by total revenues, was supported at an alpha .01. The observed p-value was .00 and the difference between family and non-family firms was 1.848 categories on average. We then looked at the interaction of the CEO education and family businesses. Neither CEO education nor the interactive term was significantly related to total revenues. The observed differences may have been due to random chance.

Next, we argue family firms are negatively associated with diversification, both product and geographic, because their managerial skills are limited to what is existent in the family, which cannot be extended if the firm diversifies, the rent extraction by the family detracts the ability of the firm to pursue investments, such as diversification, and the firm is unlikely to take on debt to fund the diversification because of the family's aversion to the control risk. We hypothesize that the relationship between family firms and both product and geographical diversification will be moderated by the CEO education. As a CEO becomes more educated, he or she may adopt managerial styles similar to CEOs in non-family firms. Our model indicates family firms are significantly and negatively related to geographical diversification at an alpha of .1. Both age of the business and number of employees were found to be insignificant as control variables. Based on our computed geographical density measure, non-family firms had a much higher density value, 10,491. This indicates they conduct more of their business outside of the local market while family firms are more likely to conduct more business in a narrower geographical proximity, such as in the local market. This is evidence in support of our hypothesis two. We considered again that CEO education may moderate that relationship, such that as CEO education increases the negative relationship between family firms and geographical

diversification will be attenuated. We found that both CEO education and the interactive term were insignificant predictors of geographical diversification. Therefore, we failed to confirm our hypothesis 2a at any reasonable level of alpha.

As with geographical diversification, we found product diversification was negatively and significantly related to family firms at an alpha of .1. The observed p-value was .055, with a coefficient of 17.66 for the family variable. This indicates that non-family firms receive 17.66% more of their total revenues from products they developed in the last two years compared to family firms. Again, we included age of the business and total number of employees as control variables. Consistent with previous studies, we included age of the business to control for an upward effect. That is, as a business ages, it will be more likely to diversify across markets and through products. The model provides significant evidence, at an alpha of .1, that the age of the business is negatively related to product diversification. We believe this may be attributable to complacency and lack of innovation in older companies. Although we only had data on product diversification in the last two years, it may be the case that the relationship is curvilinear. Initially, as firm get older, they are positively related to product diversification then at some point the relationship becomes negative. Finally, we tested for the impact of CEO education and the interaction of CEO education and family firms on product diversification. Neither CEO education nor the interactive term was significant.

Overall, we demonstrated family firms are significantly and negatively related to both product and geographical diversification. CEO education and the interaction of CEO education are not significantly related to diversification. Additionally, we found that family firms, on average, are significantly smaller than non-family firms. This lends credence to the notion that families extract resources from their businesses, which is consistent the family first ethos purported by Reid and Adams (2001).

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