

## A Study on Inheritance and Innovation in System Conversion Process of Family Businesses

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**Abstract:** While the family businesses create the miracle of growth in the trend of the world economy, the reason is the natural advantages in the early stage of family businesses: trust mechanism, capital facilities, human factors, etc. These factors become the cornerstone of the early family business. However, in the late stage of family business, its double contradictory provisions and family's control on the business limit the use and integration on social resources, resulting in the shortage of human resources, management and trust resources. The shortage restricts the sustainable growing and development of family enterprises seriously, resulting in many family businesses in trouble. Throughout the history of both Chinese and international family business, there are both the success and the failure. Some family businesses become well-known enterprises of modern corporate system, while some of them dim out in the historical stage in the second-generation heritage. In order to make up the shortcomings of family businesses, how the family businesses should inherit the advantages of the family business in the process, which innovation of the system should be adopted, a proper system designing on Game Theory is the focus. And the content of this paper is related to it.

**Key Words:** Family business; Trust mechanism; System heritage; Innovation

### 1 Introduction

As the unity of family and enterprise, family business is a kind of organization forms with strengths and weaknesses. The congenital superiority of family business in the startup makes family enterprises become a national economic force reckoned in the world. Within the scope of the most conservative estimate, the family business accounted for 65percents to 80percents of the total number of enterprises: In the United States, the recent report shows that the largest company listed is controlled by family at least 30 percents (Sharma, 2002).

Views about family businesses can be roughly classified into two kinds: the first tendency think family-based management has backwardness which isn't favor to the development and expansion of the Chinese family businesses and the establishment of a modern enterprise system. People holding such views deny private enterprise management strongly. For example, a scholar thinks that the traditional ethics trust culture makes the breadth and validity of enterprise financing be below the average degree of rational contractual system in market economy; Lee (2003) established a two stage game model to test that specific knowledge may result in high risk when hiring agents, which may be restrictive factors to family businesses transiting to modern companies. Therefore, the traditional Chinese family enterprises can't develop to the modern enterprise. The second kind of tendency thinks that we should research the phenomenon of Chinese private enterprise in specific environment and condition. The scholars holding this view think family enterprises have positive significance in contemporary Chinese society. International expert Edith Penrose researching enterprise growth theory thinks, family enterprises' growth is limited by the number and speed of absorbing new managers. Li Xinchun, Chu XiaoPing, Li HuaiZu (2003) found that most of the family enterprises' serious shortage of management resources and low level of management standardization hindered the development of the enterprise in the current stage. So the dilemma of family enterprise is temporary. Solving the existing deficiencies in trust, management resource can also make family enterprises be always young.

In this view, we are for the point of Zhou Qiren: there is no difference between family-based management and modern management in the perspective of efficiency. Family enterprises have their unique vitality. Inheritance to the governance mechanism and innovation but not giving up the management mode of the family business completely can also decide the fate of the family business after family enterprises grow up.

### 2 The Dilemma of Family Enterprises

The success of the family enterprises is often the results of entrepreneurs team's effort, sharing different skills and experience among team members (Ensley, Pearson and Amason, 2002), and it is the

results of exploiting entrepreneurs team members' human capital comprehensively and creatively. We also find that in the early period of the family enterprises family members constitute the main body of the executive team in the study. It has high family cohesion, like the type presented by Fei Xiaotong which shows a low social cohesion absorbing manager human resource low-efficiently. Li (2002) points out in the research of the dilemma of the family enterprises that only family-based trust can form the best cooperation in a certain system culture, but this kind of cooperation is not the most efficient while family enterprises grow up for most manager resource can hardly come into family enterprises. The dilemma of family enterprises means that it is difficult to realize pareto optimality based on the agency cost on the basis of the trust and the agency ability on the basis of experts ability. The fact that family management can contribute to establishing a business but not to its development urge family enterprises a second pioneering integrating the advantages of family management effectively and rational innovation in transition to a modern company system.

At the same time on the way of family business transition, it will still face the target consistency problem among shareholders, supervisors and executives. As the company owners, the shareholders' interests will be damaged directly in the game among shareholders, supervisors and executive, even if in the modern company management it can hardly realize pareto optimality. We assume that 1) the value of company as a shareholder value measuring index, and there are three cases, V1, V2 and V3 respectively; 2) As a shareholder regulator it has A and B partners, and a, b says the supervision party ratios. C says supervision cost. While A, B participate in supervision, the value of company is V1. While only one partner participates in supervision the value of company is V2. While none partners participate in supervision the value of company is V3; 3) in assume 2) three cases, it can cause the efficient behavior, the neutral behavior and none behavior. In the above assumptions, the game process of shareholders, supervisors and executives will be a sequence of dynamic game process, and its final game result will lead to family business into trouble.

**Table 1 The Game of Matrix Form of Two Supervision Parties**

		Supervision party A	
		Supervision	No supervision
Supervision party B	Supervision	(aV1-C/2, bV1-C/2)	(aV2, bV2-C)
	No supervision	(aV2-C, bV2)	(aV3, bV3)

We can draw the conclusion from the table: in the family enterprises' early restructuring, for supervisors shares is in low proportion, while the supervisory cost C is large, (no supervision, no supervision) will be a dominant strategy. So this game's Nash equilibrium is (no supervision, no supervision). It will induce the managers' irrational investment, appearing insider controlling phenomenon, leading to minimum company value. The family enterprises does not realize the maximize value.

There are at least two generations participating in the company management in the same family, and the relationship between two generations, company policy and the interests of the family will not only control the extension of trust mechanism, but also influence the introduction of management resources, affecting family enterprises' sustainable development. The ownership and managing authority of the family enterprises are controlled by the family members related by blood, marriage, genetic link in general, which is the result of the shortage of China's family enterprise regime. So there are greater challenges on inheritance to the trust mechanism and governance mechanism innovation confronted by family enterprises.

### 3 Family Enterprise Development Paths

Chu Xiaoping and Li Huaizu think not all of the family enterprises' growth path follow a specific development path or must come across each node. Family enterprises' development path has two main paths: first, the traditional family enterprises to family enterprises continuous state to abortive family enterprises; Second, the traditional family enterprise to the family enterprise to family critical holding company to public listed companies. How to keep the family enterprises to keep be young forever and to realize family enterprises from the first path to the second development path of development rely on an effective way that the family enterprises keep management mechanism inheritance and innovation rationally. It mainly involved the family enterprises going on the inheritance to trust mechanism supporting the wonders of nowadays family enterprises effectively and the rational innovation

supporting family enterprises' development in conditions of the modern enterprise system. The effective inheritance to trust mechanism can promote traditional family enterprises to modern family management mode, and the bold innovation in family governance mechanism will guide the traditional family enterprises to modern companies' management. These two kinds of means are no doubt the best goal to family enterprises.

#### **4 Exploration about Family Enterprise System Model**

Family enterprises governance itself is neutral in efficiency, which does not necessarily result in low efficiency. It is the key to discard the disadvantages and to inherit advantages respectively. The initial motivation of enterprises management innovation comes from the natural pursuing profit in a market economy environment. Douglas • North thinks that achieving profitability hardly in the existing arrangement structure leads to a new system arrangement. There is an innovation process along with the growth of the family business which means that greater the cost of opportunity is in current institutional arrangements condition, stronger the demand for the innovation is. Overall, while small-scale enterprises tend to family governance, the greater scale enterprises tend to adopt the implement of corporate governance. It is the sign of the growth to have entrepreneurial orientation when facing choosing governance mechanism. The Chinese and foreign scholars have common agreement: continuous inheritance to advantages and innovation is a necessarily process of family enterprises. Only with inheritance to advantages and entrepreneurial spirit, is the family enterprises have the ability of development. It is of great significance to design the system structure about how motivation works, not list all kinds of motivations in the inheritance and innovation system. It is the key point to redesign system structure clearly, which can promote the tendency of some people and inhibit the tendency of some other people in order to keep family enterprises be young forever.

##### **4.1 The inheritance to trust mechanism of family enterprises governance**

Scholars holding a positive attitude to family enterprises mainly explain the lasting vitality of family enterprises form from the family enterprises itself. In the process of operation with entrepreneurs as the core, it is the three factors to make the family enterprises' glory at the early stage, including the enterprise culture with a natural cohesion, information communication and knowledge transfer sufficiently for ethics and internal trust, the core competitiveness for focusing on small market.

Chu Xiaoping and Li Huaizu (2003) agree that family enterprises need to break through the performance in terms of family enterprises growing scale, the expanding of the organization structure and improving profit market which are limited. Family enterprises need to break through the sealing properties of the family management resources gradually, absorbing external professional managers and integrating human resources effectively for a longer agent chain. The author thinks that the family enterprises' advantage resource lies in the family enterprises' high trust mechanism by ethics restriction different from other enterprises. It is a significant breakthrough for family enterprises to heritage and use the advantage resources in the new stage of development.

##### **4.1.1 The inheritance to family trust mechanism**

For trust, we tend to agree with Gambetta's(Gambetta, 1988, 217 pages) definition in general: trust is a specific subjective probability level, which a person can take to judge another person or group whether take a particular action. This means that family trust refers to subjective probability estimating the family enterprises' internal member whether take a measure or not, which is also risk leading to the differences in depth and breadth of the trust. The family business culture linking with the media of emotions, blood, marriage, classmate and geopolitical may be important reasons to lead to the rapid growth in the early years. Centralized information match with enterprise's resources, and family enterprises' trust performs in high level trust when family enterprises' scale is small. But with the expansion of the scale of the family enterprises, centralized information will gradually contradict with the family resources, reducing trust gradually. Therefore, greater the scale of the enterprise is, more serious the shortage of trust resources is.

The development of Chinese and foreign family enterprises shows the importance of trust. Family enterprises' growth will necessarily face the integration of external human resources and the reconstruction of internal trust mechanisms, which will be affected by the number and the speed absorbing new management resources. It is said the real restriction to the growth of family enterprises is the shortage of trust resource. So the lack of trust resources will make family enterprises in trouble, which is a bottleneck to the growth of family enterprises in essence. So the family enterprises need to heritage and develop on the advantage trust resources.

**Table 2 The Matrix Form of Two Supervision Parties' Game with Trust Mechanism**

		Supervision party A	
		Supervision	No Supervision
Supervision party B	Supervision	(aV1-C/2, bV1-C/2)	(aV2, bV2-C)
	No Supervision	(aV2-C, bV2)	(aV3, bV3)

At this point, if the family enterprises will heritage trust mechanism effectively, the dominant strategy of the game is (supervision, supervision) because although the share proportion is low in family governance conditions, that is, a and b small, its supervision cost falls close to zero, that is, C is very small. Executive takes the rational decision, and company value will achieve optimal results V1, achieving family enterprises' maximize value goal expected in family governance conditions. In view of this, first we should gradually establish a mechanism combining relationship trust and contract trust. We gradually strengthen relationship trust and consolidate the contract trust at the same time according to the development phases of family enterprises because the radius of contract trust is big which can be even infinite and outspread to the outside experts, while the radius of relationship trust is small. Bringing family care into the family governance system and introducing reliable external consultant to mediate family contradictions can help family members to go over the difficulties shoulder and shoulder.

**4.2 The innovation on family enterprises modern governance mechanism**

Family enterprises' scale expansion, the increase of business and the radius expansion of business activities will often bring challenges to the enterprises. Li Xinchun found that the conditions of supply and demand will become more and more serious for the family enterprises' demand for management resources caused by its rapid linear growth can't be satisfied by market supply at this time. Therefore, integration on management resources becomes an important issue.

Maybe Alfred Chandler, a famous enterprise historian, proposed second form of modern enterprise system as China's family enterprise development example. The second form of modern enterprise system point to family or owners are still relative or absolute holders participating in senior management. To a degree, the family still controls the enterprise, but much of the outside senior managers participate in senior management at the same time generally achieving socialization. Now controlling family changing to family supervision committee, and introducing institutional investor supervision will become a way solving the bottleneck restriction.

In charge of the assumptions of family enterprise dilemma, the game of shareholders, supervisors and executives will reach the target of maximize value of pareto optimality.

**Table 3 The Game for the Matrix Form of Family Controlling Shareholders and Institutions**

		Family supervision committee party A	
		Supervision	No supervision
Family supervision committee party B	Supervision	(aV1-C/2, bV1-C/2)	(aV2, bV2-C)
	No supervision	(aV2-C, bV2)	(aV3, bV3)

At this time, as a whole family supervision committee, its large shareholders role, its larger proportion, its strong ability of company information collection and analysis, supervision cost is low and the dominant strategy of the game is (supervision, supervision). Now executives take rational decisions, achieving the optimal company value V1, which is the maximize expectations of family enterprises' value.

To achieve the goal of second form of the modern enterprise system, the family enterprises must change existing ownership structure, human resources structure in various aspects. So family members lack of experience in business management should be supervisory personnel. Their closely relation to the interests of the company and being more familiar with the company will reduce the supervision cost, performing effectively as a constraint to management personnel. At the same time the supervision commission's large shares proportion will reach pareto improvement of agency cost and agent ability, which is similar to introducing institutional investors.

**5 The Conclusion**

As an important part for the economy in China, there must be rationality of the system which does not exist in other types of enterprises. in this study we make conclusions as follows: 1) We should

strengthen inheritance to trust mechanism and the bold breakthrough in the course of the family enterprises' development to keep stable of the trust , realizing the maximize value of family enterprises; 2) We should keep inheritance to reasonable composition of family governance mechanism based on family trust and introduce family care to modern management system to relieve the moral risk and adverse selection problem; 3) We should pay more attention to changing family controllers to supervisors and introducing the institutional investors to realize the Pareto Optimality of agency cost and agent ability in this process ; 4) We should change in the guide of the bold innovation thought, realizing pareto efficiency optimal of loyalty and ability.

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