Not just in it for the money

September 17, 2009

Family-owned businesses are best aligned with profit maximization, but owner-managers frequently pursue non-pecuniary objectives.

Management research predominantly assumes that the goal of business is to maximize profits, and a failure to do so is seen as dysfunctional. But in research supported by IESE's Public-Private Sector Research Center, Brian T. McCann and Govert Vroom show that owner-managed businesses manifest a more complex set of motivations than the simple matter of making as much money as possible. In their paper, "Ownership Structure, Profit Maximization and Competitive Behavior," they show that, contrary to expectations, the competitive behaviors of professionally managed businesses are more acutely geared to profit maximization.

Agency theory posits that the split between ownership and control in the modern corporation can lead to non-profit-maximizing behavior, if the incentives of managers are not aligned with those of the owners. In the absence of aligned incentives, managers act to maximize their individual utility, not organizational profit. Only in the case of common ownership and control are incentives perfectly aligned. One might expect, then, that owner-managers would behave more in line with profit maximization than professional managers.

The authors argue, however, that this expectation might not be warranted because the separation of ownership and control might also affect the goals of firm owners. This effect suggests to them that professionally managed firms may behave more like profit maximizers than owner-managed firms. They cite entrepreneurship literature that clearly shows that entrepreneurs are motivated by both financial and non-financial considerations. Research shows that self-employed individuals give reasons such as authority, autonomy, challenge and self-realization as motives for their career choices.

Structure determines behavior

A key assumption underlying the typical view of firms as profit-maximizing entities is that owners' utility maximization goals are best served by firm profit maximization.

The authors, however, believe the applicability of this assumption is related to the ownership structure of the firm, and is less applicable to owner-managed firms as these owners can directly derive non-financial benefits from the firm, for example, in the form of autonomy and self-realization. In contrast, the dispersed, external owners of professionally managed firms only derive financial benefits from ownership. Moreover, a variety of mechanisms are commonly in place to align managers' interests with this profit maximization goal, leading to a higher likelihood of profit maximizing behavior.

In the development of their hypotheses, the authors first consider the role of non-pecuniary motives on entry and exit behavior.

Entry Behavior. Professional managers are more influenced by expected future profitability and are, therefore, more likely to enter more economically attractive markets. Owner-managers, in contrast, have more idiosyncratic, non-monetary objectives, which they evaluate in addition to market attractiveness.

So, their first hypothesis is: the positive relationship between the economic attractiveness of a market and likelihood of entry will be stronger for professionally managed firms than for owner-managed firms.

Exit Behavior. With regard to exit strategies, professional managers will evaluate the net present value of continuing in business versus the shut-down value of the business. Owner-managers, on the other hand, will consider the non-financial returns of continuing operations, in addition to the financial returns. The authors cite evidence showing that owners who gave non-financial motives for being in business were less likely to exit given similar levels of performance.

The authors contend that this focus on non-pecuniary benefits leads to a weakening of the negative relationship between measures of the economic attractiveness of a particular market and the probability of exit. This leads to
their second hypothesis, that the negative relationship between the economic attractiveness

of a market and likelihood of exit will be stronger for professionally managed firms than for owner-managed firms.

Pricing Behavior. The authors then go on to consider pricing behavior and contend that the prices of owner-managed firms will be less responsive to the underlying economic attractiveness of their local markets.

Owner-managers benefit from financial and non-financial returns, and there is evidence that aggressive price increases in response to higher market demand may jeopardize one such source of non-financial return - recognition, which can be increased through higher sales volumes.

From this flows the third hypothesis: the positive relationship between the economic attractiveness of a market and firm prices will be stronger for professionally managed firms than for owner-managed firms.

Heterogeneous zones

The authors conclude that management theory has largely adopted profit maximization from economic theory and ignored other potential objective functions. The main claim of their research is that the field of strategic research management needs to recognize the impact of another level of heterogeneity across firms - heterogeneity in objective functions in order to better understand firm behavior.

Owner-managers are motivated by utility maximization, while specialized owners - owners who do not have a management role in the firm - are motivated by profit maximization.

The entry, exit and pricing decisions of owner-managed firms are all relatively less responsive to the underlying economic attractiveness of the markets in which they operate.

A clearer understanding of the goals of the firm improves our ability to explain and understand their behaviors.

www.iese.edu/insight