RISK PREFERENCE OF FOUNDER AND DESCENDANT OF INDONESIAN FAMILY FIRMS

Putri A.C., Viverita V.*

Abstract: This study aims to investigate the role of CEO succession in family business and the effect on financial risk. Using a Generalized Least Square (GLS) regression analysis and unbalanced panel data of 48 family firms, the stagnation, agency perspectives, and signaling model of their behavior were tested. This study finds that CEO turnover is negatively associated with firm's financial risk. Furthermore, CEO descendants are more risk averse than CEO founders, and older CEOs are also more risk averse than younger CEOs. In addition, CEOs with higher education are also more risk averse. This implies that the Indonesian family firms are conservative towards financial risk. In relation to the stagnation perspective, the decrease in financial risk of family firms in Indonesia will be premature to be concluded that it will be in a stagnant phase.

Key words: Family Firms, Succession, Founder, Descendant, Risk Preference

DOI: 10.17512/pjms.2019.20.2.35

Article history:
Received September 10, 2019; *Revised* November 14, 2019*; Accepted* December 11, 2019

Introduction

CEO succession is considered to be the critical factor and issue in the management of an organization (Chen et al., 2016). Martin, Gomez-Martin, et al. (2013) suggested a behavioral agency model whereby family firms tend to behave in a risk-aversion manner as regards their wealth prospects and sacrifice the socioemotional aspect by choosing professional CEOs. This decision is due to family firms believing that professional CEOs are acting as stewards (Chang and Shim, 2015). Stewardship will determine how CEOs work on behalf of a company, so they are more likely to act for the benefit of the firm rather than the individual (Miller et al., 2008).

Family members may have a strong desire to maintain top management positions in the family to maximize socio-emotional wealth, and that can sometimes be a burden on profits (Gomez-Mejia et al., 2011). Ajzen (1991) suggested that a person's behavior will depend on the intention of individuals in carrying out certain practices. Family ties affect and strengthen the demeanor of an individual, with a better attitude on the part of successors being perceived to have a positive effect on the value of the firm. The purpose of this study is to feel the gap in the literature on family succession. It examines the different behavior of founders and descendants towards their risk-taking behavior of financing decisions. Specifically, what the

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effects are on the financial risk levels. So, this paper studies how CEO behavior of family firms in Indonesia affects its financial risk.

Literature Review

Family Business Succession in Indonesia

Based on a survey conducted by Price Waterhouse Cooper (PwC, 2014), it shows that first-generation or a founder leads 23% of family firms in Indonesia, 37% lead by the second generation, and 33% are managed by the third. There was mix evidence of delegating family firms from founders to the next generation. Some of them were a success, and others failed. Lehman Brothers went bankrupt because of its inability to overcome agency problems in the company, besides an issue of high leverage and limited equity (Kim, 2016). In the case of Indonesian family firms, Bouraq is one example of a story when descendants from the second generation failed to continue the benefactor success story. The company is declared bankrupt after it transferred to the second generation. The firm's financial performance worsening after the 1998 crisis and finally declared bankrupt in 2005 (Koran Sindo, February 17th, 2016). Another bitter story experienced by PT. Nyonya Meneer, which declare bankrupt by the District Court of Semarang due to its non-performing loan of 89 billion rupiah. Although its herbal medicine products still attractive to the market, the third generation failed to manage the business mostly due to internal problems.

In contrast, Sinar Mas Group and PT Djarum were able to maintain the company's performance from generation to generation until today. As the proof of its achievement, Indonesia Brand Forum 2016 awarded Sinar Mas Group for Succession Management and to PT Djarum for Sustaining Success / Longevity. Another family firm in Indonesia who maintain their success after succession is Martha Tilaar Group. Martha Tilaar Group, who is currently led by the second generation, Bryan Tilaar, continues to spread its business wings and received the World-class Quality Achievement Award in 2013. Another example is the Bluebird, a transportation company. It proved that they could maintain its existence in the fierce competition in the transportation sector after the succession. Currently, Bluebird led by the CEO of the third generation and is continuously striving to develop and adapt to the condition of transportation competition in Indonesia.

This phenomenon give evidence to Theory of Planned Behaviour proposed by Ajzen (1991) which explains some important issues such as the existence of succession in the family firm. This theory states that a person's behavior depends on the intention of individuals in performing certain behaviors. The intention means the motivation that influences the formation of behavior. The greater the intention, the more likely it will be happened. The behavior of an individual is also determined by the belief in the outcome of the behavior. This theory can explain how the succession of succession in the family company. The better the behavior demonstrated by the successor is believed to increase the firm's value.

Succession and Financial Risk

A model proposed by Ward (1997) distinguishes the orientation of a family firm where the first generation tends to be business-oriented, to maintain and develop its firm to achieve high profitability compared to the next generation who tends to be family-oriented. Business-oriented firms will have a higher growth capacity, whereas family-oriented firms focus on business stability and inheritance to the next generation (Reid et al.,1999). Family-oriented firms are more reluctant to use risky external sources of capital, as this could dilute family control (Molly et al., 2010). Martin and Lumpkin's (2004) also find that family companies led by a descendant are reluctant to use external capital because they are considered risky and can reduce family control.

Miller, Le Breton-Miller, and Scholnick (2008) introduced a stagnation perspective that stated that a change of leadership from the first generation to the next generation would lead family companies to be in a stagnation phase where companies will have a declining growth. This situation indicates that the descendants tend to be risk-averse to maintain the survival of the company. Therefore, they tend to avoid using debt. It consistent with Beckhard and Dyer (1983) and Paul (1996) argue that conflict within families is a significant factor in the failure of family firms so that creditors tend to reduce the desire to provide debt to family firms in the next generation. Agency problems arise within the family enterprise and will continue to increase with succession to the company (Davis and Harveston, 1999; Smith and Amoako-Adu, 1999). By using the agency perspective, Schulze et al. (2003) state that equity ownership will be more widespread in families in the next generation. Family members who are not actively involved in the business will encourage the use of debt financing because debt used as a corporate governance mechanism that reduces agency costs. Thus, it expected that family firms in the next generation would increasingly rely on debt as corporate funding. A study by Schulze et al. (2003) proved that descendants are more willing to accept risks and use debt for investments (Eforis, 2018).

Family members who are not actively involved in the business will encourage the use of debt financing because debt used as a corporate governance mechanism that reduces agency costs. Thus, it expected that family firms in the next generation would increasingly rely on debt as corporate funding. A study by Schulze et al. (2003) proved that descendants are more willing to accept risks and use debt for investments. Therefore, based on the stagnation perspective, and agency perspective, the hypothesis can be written as:

H1: Succession in family firm significantly affect the firm’s financial risk

CEO age and financial risk

Based on the career perspective, younger CEOs will tend to be risk-averse so that the firm will have a conservative investment policy (Holmstrom, 1999). On the other hand, the signaling model by Prenderngarst and Stole (1996) suggests that younger CEOs give the signal to the market that they are qualified by demonstrating their superior capabilities by engaging in riskier and aggressive

investment strategies. Older CEOs tend to be committed to maintaining company sustainability and have a view that financial and career certainty is the most important. The hypothesis is as follows:
H2: CEO's age significantly affects the firm's financial risk

CEO education and financial risk

Cannella, et al. (2009) note that CEOs with higher educational levels are more willing to take risk. Bertrand and Schoar (2003) stated that CEOs with a higher education are more aggressive and are positively associated with a level of capital expenditures and debt. Higher education executives tend to invest if growth opportunities are high. On the other hand, MacCrimmon and Wehrung (1990) found that Canadian executives with lower education are more risk taker than executives with higher education. There is also evidence that managers with more education are more actively involved in corporate hedging as evidenced by their increased use of derivatives (Pennings and Garcia, 2004; Bodnar et al., 2013). The hypothesis is as follows:
H3: CEO's education significantly affects firm's financial risk

Research Methodology

The Authors collect information and data of family firms listed in the Indonesia Stock Exchange from the Thomson Reuters, www.idx.co.id and Indonesian Capital Market Directory (ICMD) for the period of 2007-2016. A firm is defined as a family firm when at least 25% owned by a family or a particular family member. When the ownership is less than 25%, then at least one of the family members is a CEO (Andres, 2008). The study used 48 family-controlled listed firms, excluding financial firms, who are consistent to do family succession. The dependent variable of this study is firm's financial risk which is measured by financial leverage. Financial leverage is the rate of use of external funds (debt) to finance the firm's assets. The debt increases the risk faced by the firm because of the risk of default in debt. Financial leverage is defined by total debt divided by total asset (Molly, 2010).
The independent variable is CEODUMMY that classifies firm in the sample into founder or descendant. This variable will be 1 if a firm is led by a descendant and 0 otherwise. This variable is constructed to differentiate family firms with non-family firms (Villalonga and Amit ,2006). In addition, CEOAGE is represented how old is the CEO of the firm. The data is retrieved from Annual Report of each of company that is listed at the Indonesia Stock Exchange (Serfling, 2014). Education (EDU) represents CEO's ability that is measured by the years of CEO's study. The Authors use returns on Assets (ROA) as proxy for profitability and measure it as net income divided by total asset. Furthermore, GROWTH is measured as market to book ratio, while SIZE is considered as how big is the firm (Molly, 2010). SIZE of firm is defined by the logarithm of total assets. The authors also consider firm's age as control variable. FIRMAGE is defined as the year since

the company stood until the year of the study conducted (Huynh and Petrunia, 2009), and is measured as the actual firm's age.

This study is conducted using a Generalized Least Square (GLS) regression analysis to test the effect of family business succession on firm's financial risk. The first model aimed to determine the effect of family business succession, in this case, is the effect of CEO status that is founder or descendant, as well as the effect of CEO's age and education on corporate financial risk. The empirical model is as follows:

$$LEV_{i,t} = \beta_0 + \beta_1 CEODUMMY_{i,t} + \beta_2 CEOAGE_{i,t} + \beta_3 EDU_{i,t} + e_{it} \quad (1)$$

The second model aimed to determine the effect of family business succession on the company's financial risk, by controlling several company-specific factors such as profitability, firm growth, firm size, and firm's age. The empirical model is as follows:

$$LEV_{i,t} = \beta_0 + \beta_1 CEODUMMY_{i,t} + \beta_2 CEOAGE_{i,t} + \beta_3 EDU_{i,t} + \beta_4 ROA_{i,t} + \beta_5 GROWTH_{i,t} + \beta_6 SIZE_{i,t} + \beta_7 FIRMAGE_{i,t} + e_{it} \quad (2)$$

$LEV_{i,t}$ is financial leverage; $CEODUMMY_{i,t}$ is dummy variable, takes the value of one (1) if the firm is led by a decendants and zero (0) if the firm is led by a founder; $CEOAGE_{i,t}$ is the CEO's age; $ROA_{i,t}$ represents return on assets; $GROWTH_{i,t}$ is growth the firm's market to book ratio; $SIZE_{i,t}$ represents the size of firm; $FIRMAGE_{i,t}$ is the age of firm.

Results and Discussions

This section presents the descriptive statistics as well as the analysis of the results. Table 1 describes the value of mean, minimum, maximum, and standard deviation of the data used in the study. Based on Table 1, the average value of financial risk as measured by the leverage (LEV) is 0.257574, the maximum value of financial risk is 0.739236 and the minimum value of 0.000610. CEODUMMY variable is a dummy variable in which 1 is a company led by descendant and 0 is a company led by the founder. The average value of this variable is 0.451411. This value shows that a founder still leads the majority of family firm in Indonesia. CEOAGE variable shows the age of the CEO of the company. The average age of CEO of a family company in Indonesia is 56.21 years. The highest score for CEO age is 89 years old and the minimum is 27 years old. The average value of CEO's education in Indonesia is 15.86. EDU variable has a maximum value of 23 and the minimum value of 9. These indicate that the highest education of the sample CEO is a doctoral degree, while the lowest education is junior high school. The profitability variable calculated by using return on assets (ROA). The average value of

profitability is 0.047495. ROA has a minimum value of -0.548466 and the highest value of 0.260610.

Table 1. Descriptive statistics of variables

VARIABLE	MEAN	MAXIMUM	MINIMUM	STD. DEV
LEV	0.257574	0.739236	0.000610	0.177038
CEODUMMY	0.451411	1.000000	0.000000	0.498415
CEOAGE	56.20690	89.00000	27.00000	10.83820
EDU	15.86207	23.00000	9.000000	3.033322
FIRMAGE	31.07837	50.00000	13.00000	9.007167
GROWTH	2.062186	13.02457	0.129257	2.435835
ROA	0.047495	0.260610	-0.548466	0.080180
SIZE	27.73923	32.15098	25.27880	1.337902
FOUNDER AGE	61.22222	89.00000	42.00000	8.783682
DESCENDANT AGE	49.90278	67.00000	27.00000	9.300966
FOUNDER EDU	14.52083	23.00000	9.00000	3.650785
DESCENDANT EDU	17.34028	12.00000	19.00000	1.338840

GROWTH is measured by the market to book ratio and has an average value of 2.062186. The maximum value of growth is 13.02457, and the minimum value is 0.129257. The age measured by the period from its establishment up to the beginning year of this study. The average value of the family firm's age in Indonesia is 31.07837. It has a maximum value of 50 and the minimum value of 13. The size variable (SIZE) illustrates the size of a company measured by using natural logarithm total assets. The average value of firm's size is 27.73923. SIZE variable has the maximum value of 32.15098 and the minimum value of 25.27880.
Table 1 shows the average of the founder's age is 61.22222 or 61 years. The maximum age of founder is 89 years and the minimum value of the founder is 42 years. The average age of descendants is 49.90278 or 50 years. The maximum value of descendant's age is 67 years and the minimum value of descendant's age is 27 years. The number of founders who lead the family firms in the sample research are 31 people or 57%, and the number of descendants are 24 people or 43%. It can conclude that the average of descendant's age is not much different from the average founder's age. Table 1 also shows that the average of the founder's education is 14.52083 or between high school and bachelor's degree. Meanwhile, the average of descendant's education is 17.34028 or a bachelor's degree. The maximum value of the founder's education is 23 years, or a doctoral degree, and the minimum value of the founder's education is 9 years or junior high school level. The maximum value of descendant's education is 19 years or a master's degree, and the minimum value is 12 years or high school level. It shows that descendant's education is higher than the founder's education.

The following tables present the results of model estimation related to the role of family succession on the firm's financial risk. We apply Generalized Least-Square Weights estimation in the form of cross-section weights and coefficient of the Covariance method of the white cross-section — the estimation results provided in Table 2 and Table 3.

The results on both models in Table 2 and Table 3 consistently show that CEODUMMY has adverse and significant effects on financial risk. The negative coefficient indicates that a family firm led by a descendant has a lower financial risk than family firms led by the founder. This result confirms the stagnation perspective suggest by Miller and Scholnick (2008), which propose that descendant is more risk-averse.

Table 2. Estimation Results Model 1

Variable	Coefficient	Prob.
C	1.780109	0.0000
CEODUMMY	-0.386479	0.0004*
CEOAGE	-0.005021	0.0047*
EDU	-0.067196	0.0001*
R-squared		0.775962
Adjusted R-squared		0.741558

This result is in line with Kaye and Hamilton (2004) and Molly et al. (2010), who found that family firms are more risk-averse after the succession. This situation may have happened since the focus of the next generation is to maintain prosperity, so they apply a low level of debt. A decrease in financial risk indicates better risk management in family firms.

Table 3. Estimation Results Model 2

Variable	Coefficient	Prob.
C	0.364855	0.6781
CEODUMMY	-0.469450	0.0004*
CEOAGE	-0.007382	0.0024*
EDU	-0.067523	0.0001*
ROA	-0.531729	0.0000*
SIZE	0.060898	0.0139**
FIRMAGE	-0.002232	0.4913
GROWTH	-0.001958	0.4002
R-squared		0.801401
Adjusted R-squared		0.767814

A proper succession planning by the founder will further improve the firm performance both during the transition period so that succession will not increase

the risk. This result implies that the higher risk- aversion and the lower willingness to attract debt financing will reduce the choice of financing resources for the next generation of family firms. Family firms in Indonesia will not make a succession within ten years. This fact shows that the process of succession planning by previous generations takes a long time and requires careful consideration of all aspects.

However, some family companies in Indonesia do family succession in the short term, such as Sido Muncul Tbk, who replace their CEO every three years. Besides, family firms that lead by the descendants are less likely to be exposed to conflicts since the CEOs had experience from their founder. Moreover, the strong influence of the founder is one of the foundations of the success of family firms. The reputation of a good founder will continue to be maintained by the descendants so that the firm's performance will be strong and reduce the probability of default. Founder's reputation is a critical factor for the company to attract financial resources that can support its future firm's strategy (Mazzola et al., 2006). The results are also in line with some studies on developing countries by Hamid et al. (2015) and Machek and Hnilica (2015) in Malaysia and the Czech Republic, respectively. They suggest that family firms tend to use internal funding, and non-family firms tend to use external financing. This phenomenon is proof that the family company has planed family succession (Amran and Ahmad, 2010). Seventy percent of family businesses in Indonesia have a succession plan, while 27% of them have a succession plan in place that is robust and documented. This number is higher than what globally do. That is, only 53% have an idea of succession, and 16% have a succession plan that is robust and documented (PWC, 2014). These results are also in line with a study by Fan, Wong, and Zhang (2012) in Hong Kong, Singapore, and Taiwan, that the leverage rate of family firms declines after succession.

Both results in Table 2 and Table 3 consistently indicates that older CEOs have lower financial risk. This result implies that descendants who are considered younger have a higher financial risk. This result is consistent with the signaling model that the less experience CEO is more risk-taker (Prendergast and Stole, 1996)., and the agency perspective (Schulze et al., 2003), that the next generation is actively using debt, so they more risk-taker compare to the founder. The descriptive statistical analysis can explain the finding in Table 1. It shows that the average CEO's age is not much different. There are no significant age differences between founders and descendants when they start a business. Besides, out of a total of 319 observations, 176 observations are led by a founder. This result proves that the founder still controls most family companies in Indonesia so that the results are more represent the founder's age**.**

Our empirical result also showed that there is a significant adverse effect between CEO education and a firm's financial risk. This result implies that more educated CEOs will lessen financial risk than less knowledgeable CEOs. It is in line with Belghitar and Clark (2012), who also find a negative and significant effect between

CEO education and the firm's risk. This result proved that education is associated with the CEO's risk management ability (Davydov, 2014). CEOs with higher education can be more agile to respond to the firm's problem so they can better manage the financial risk. The CEOs with more training are more actively involved in corporate hedging, as evidenced by their increased use of derivatives (Pennings and Garcia, 2004; Bodnar et al., 2013). This finding also implies that the CEO with higher education will have more knowledge of how to manage financial risk. Concerning the stagnation perspective, the decrease in the financial risk of family firms in Indonesia will be premature to conclude that it will be in a stagnant phase. A survey by PwC (2016) mentions that 44% of respondents rated the income of family companies will have a negative growth due to the economic slowdown in Indonesia. This situation forces the majority of family firms in Indonesia to depend highly on their internal funds, while external financing will further enhance the company's ability to invest and keep family firms from entering a stagnant phase.

Conclusion

Family firms in Indonesia tend to continue their success in their families. Given empirical results show that family firms in Indonesia have a lower financial risk when led by a descendant compared to when a founder leads a company. It proved that family firms have sufficient experiences from the previous succession so that they can overcome conflicts that may affect corporate risk. The older CEOs of family companies in Indonesia also tend to be conservative and reluctant to take more debt that will increase the uncertainty in the long run. CEOs with higher education also tend to be more risk-averse. This behavior may occur due to the primary purpose of family firms in Indonesia, which is not solely to increase the value of the company. Besides, they also aim to increase the wealth of the family by maintaining the reputation, prosperity, and the sustainability of family business that has been prepared founder for future generations.

The study is subject to limitations. First, the sample is the Indonesian family firms comprised of all industries, therefore, limiting the analysis of industry-specific effect. So, it beneficial to consider such an impact in the investigation. Second, the Authors did not account for the specific CEO tertiary education level, such as an MBA or non-MBA. Indeed, the study has relevant practical implications for family firms. The family firms must consider empowering higher education CEO descendants to reduce their financial risk.

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PREFERENCJA RYZYKA FUNDATORA I POCHODZENIA INDONEZYJSKICH FIRM RODZINNYCH

Streszczenie: W artykule przedstawiono rolę sukcesji dyrektora generalnego w firmie rodzinnej i jej wpływu na ryzyko finansowe. Wykorzystując analizę regresji Uogólnionego Least Square (GLS) i dane niezrównoważonego panelu 48 firm rodzinnych, przetestowano stagnację, perspektywy agencyjne i model sygnalizacyjny ich zachowania. Badanie wykazało, że zmiana prezesa jest negatywnie związana z ryzykiem finansowym firmy. Ponadto potomkowie CEO są bardziej niechętni do ryzyka niż założyciele CEO, a starsi CEO są bardziej niechętni do ryzyka niż młodsi CEO. Ponadto prezesi z wyższym wykształceniem są również bardziej niechętni do podejmowania ryzyka. Oznacza to, że indonezyjskie firmy rodzinne były konserwatywne wobec ryzyka finansowego. W odniesieniu do perspektywy stagnacji zmniejszenie ryzyka finansowego firm rodzinnych w Indonezji będzie zbyt wcześnie, aby stwierdzić, że wystąpi faza stagnacji.

Słowa kluczowe: firmy rodzinne, sukcesja, założyciel, potomek, preferencje ryzyka

印尼家族企业创始人和后裔的风险偏好

摘要:本研究旨在调查首席执行官继任在家族企业中的作用及其对财务风险的影响。使用广义最小二乘(GLS)回归分析和48家家族企业的不平衡面板数据，测试了企业行为的停滞，代理观点和信号模型。这项研究发现，首席执行官的离职与公司的财务风险负相关。此外，CEO的后代比CEO的创始人更能规避风险，而年长的CEO则比年轻的CEO更能规避风险。此外，受过高等教育的CEO也更倾向于规避风险。这意味着印尼家族企业对金融风险持保守态度。从停滞的角度来看，印度尼西亚家族企业财务风险的下降尚为时过早，因此得出结论认为它将处于停滞状态。

关键词:**家族企业继承创始人后代风险偏好**