

## Factors Affecting the Succession Process of the Family Business in East Java, Indonesia

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**Abstract:** The purpose of this research is to analyze the factors affecting the succession process in the family business in East Java, Indonesia. The variables used in this research are succession planning ( $X_1$ ), preparation of heirs ( $X_2$ ), relationships among family members ( $X_3$ ) as independent variables while succession process ( $Y$ ) and post transition business performance ( $Z$ ) act as dependent variables. Questionnaires are used to collect the study data. Additionally, quantitative analysis with path analysis is used as analysis tool. The population in this study is medium and large scale family business in Surabaya, Sidoarjo, Mojokerto, Pasuruan, dan Gresik. Samples are taken from 43 family businesses with total employment of minimum 20 and have performed at least one generational transition.

The statistic analysis findings reflect the non-significant relationship between succession planning and preparation of heirs towards successful transition. While relationships among family members gives the most significant influence on the successful transition, as well as the significant influence between succession process to the post transition performance.

**Key words:** succession planning; preparation of heirs; relationships among family members; succession process; post transition business performance

**JEL code:** D

### 1. Introduction

Family business takes important role in the global business in the world as they rule more than 80% of total world economy and approximately 75% of world's gross domestic product (GDP) (Pousa, 2007). The same situation occur in Indonesia where 96% or 159,0000 out of 165,000 companies in Indonesia are family managed businesses (Pikiran Rakyat, 2006) and contribute to 82.44% of national gross domestic product (Suara Merdeka, 2010).

Indeed not many family business can survive and grow from generation to generation. According to Family Business Editor Review in United States of America only 30% can survive until the 2nd generation, 12% up to the 3rd generation, and only 4% surviving up to the 4th generation and below (Astrachan, Family Business Editor Review). Meanwhile in Asia only 33% can survive until the 2nd generation, 15% up to the 3rd generation, and only 9% surviving up to the 4th generation and below (INSEAD InnovAsia's Team, 2006). In Indonesia, similar situation occur where 78% of family business are run by the founder, while 15% run by 2nd generation and only 7% by the 3rd generation according to a survey done by Jakarta Consulting Group.

Family business faces some challenges such as the conflicts of business value and direction among founder

and the successors, the differences of characters and expectation among family members in making decision, position and remuneration for the family members involved in the business and the lack of long term planning in the family business. Therefore it is necessary to plan a succession process in order to maintain the continuity growth of the family business and to keep a good relationship among the family members. According to research by KPMG enterprise (2011) main key of a succession process is comfortable level between two party, i.e., meeting the expectation of the founding generation and the acceptance of successor on the family business rules about management's responsibility, compensation, profit sharing, etc.

## 2. Literature Review

The definition of a family business itself is effectively described by Davis (1983) as an organization where its policies and management is strongly influenced by one or more family members. Because family itself plays such a significant role in the company, family business is generally believed to be resistant to change by being overly dependent on family values. Balancing between optimum company expansion and fulfillment of family needs is also a constant challenge for family businesses (Palacios et al., 2013). The succession process for the next generation is inevitable for a family business, yet only a few could survive. More than 70% of businesses died out after the second generation, with the number increasing to 90% after the third generation. A few important components of a long-lasting family business can be seen below.

First, a detailed long-term plan is needed to ensure the process runs smoothly. A sufficient plan will allow the company to set out a process to determine the most suitable inheritor, including a specific time frame for the entire procedure. Ideally the company will also need to involve outside opinion and consultation, and make sure that everyone involved in the company is aware of the succession that is about to take place.

The second crucial step is preparing the future generation and making sure they have the managerial and leadership capabilities needed to lead the company. Some good preparation strategies include providing high-level education, exposing candidates to work experience outside the family business, and one-on-one mentoring from the senior to the successor to transfer the company vision and mission.

Third is maintaining a healthy relationship between the senior and the successor, especially during the transition period. Either an unwillingness by the incumbent to part with the powerful role in the company, or an unwillingness by the successor to learn from their seniors can cause substantial issues during the succession. It is vital for successors regardless of their education level to learn firsthand from their seniors in managing the company, because those skills can never be learned through formal education alone.

A fourth key component is regular communication among family members, which can reduce the risk of conflict both in the business and in the family. Regular meetings among all family members involved must be done to make sure everyone is on the same page. Indications of positive communication include the presence of clear rules and boundaries among members, the ability to solve disputes effectively and the presence of unified support from all family members (Morris, 1997).

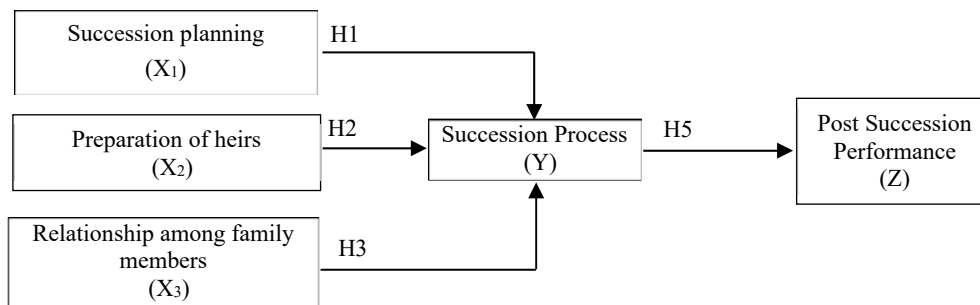
This study judges the success of a family business succession through the following criteria: the increase in company sales, the increase in the number of employees, the increase in company assets, and new product availability and growth in market share.

Prior to the writing of this paper, extensive research had already been conducted on the concept of the family business and the components that contribute to its success. A study by Palacios et al. (2013) found that family-

oriented businesses tend to view their company as a means for family members to gain a living, placing more emphasis on providing jobs for family members as opposed to thinking about the company legacy and recruiting the best professionals for important leadership roles. Another study by Wang et al. (2004) was conducted to small-middle scale family businesses (having maximum 250 employees) in UK to identify the relationship between succession issues towards the business performance of the company. In Italy Bigliardi and Dormio (2009) performed a study to identify the contributing factors of successfully inheriting a family business. Having a well thought out succession plan over an extended period, keeping a well-educated family background, and enforcing strict rules by sticking to family values are a few aspects that are highlighted to ensure a successful generational change in a family company.

### 3. Hypothesis Generation

Based on earlier discussion and using the factors of family business succession have been identified by researcher, i.e.: succession planning ( $X_1$ ), preparation of heirs ( $X_2$ ), relationships among family members ( $X_3$ ) as independent variables while succession process ( $Y$ ) and post succession performance ( $Z$ ) act as dependent variables, below model is generated:



**Figure 1 The Conceptual Model**

Source: adapted from Wang et al. (2004)

H1: Succession planning is positively related to succession process

H2: Preparation of heirs is positively related to succession process

H3: Relationship among family members is positively related to succession process

H4: Succession planning, preparation of heirs, and relationship among family members are simultaneously related to succession process

H5: Succession process is positively related to post succession business performance

### 4. Research Methods

This descriptive quantitative research uses survey method towards the population of medium to big scale family business — using the indicator of Biro Pusat Statistik, i.e., hiring more than 20 employees — in Indonesia that have survived at least one transition or succession in the business. Surveys were done in some area in East Java province including Surabaya, Mojokerto, Pasuruan, and Gresik area within the time frame in July-October 2015 collecting data from 73 family businesses. Independent variable of succession planning ( $X_1$ ) using in the research are measured by indicators such as *B1* the selection process of heir, *B2* definition of time span, *B3* hiring of consultant, *B4* stakeholder awareness, *B5* company rules about succession. Preparation of heirs ( $X_2$ ) used indicators of *B6* formal

education, *B7* mentoring and training, *B8* working experience outside the family business and *B9* entry position. Independent variable  $X_3$  (relationship among family members) used some indicators such as *B10* open communications, *B11* regular meeting among family member involved in the business, *B12* regular gathering among family members involving and not involving in the business, *B13* family business rules, *B14* mechanism of conflict resolution, *B15* support of family members towards family business, *B16* formal discussion of family members involved in the business, *B17* formal discussion of family members involved and not involved in the business, *B18* rules for the family members in relation to the business. Meanwhile the dependent variable Succession Process ( $Y$ ) uses some indicators such as *C1* time span of succession, *C2* successful transition, *C3* willingness to delegate authority and control to the heirs, *C4* control of business is taken by heirs. The other dependent variable Post Succession Business Performance ( $Z$ ) is measured by indicators *D1* sales growth, *D2* employee growth, *D3* asset growth, *D4* product line growth and *D5* market share growth.

A questionnaire with cover letter was sent to the managing directors of these family businesses of total 126, while 105 replies were received. Quantitative data analysis was done after all questionnaires collected and data were classified, tabulated and coded in order to be processed. However before data analysis was done, some instrument tests were performed, i.e., validity test with Pearson correlation method and reliability test with Cronbach's alpha method. Path analysis was performed to examine the influences of intervening variables dan to determine the relationship pattern among three or more variables (Latan & Ghazali, 2013). This technique is used to measure the contribution showed by path coefficients in every path diagram of causal relationship among variables  $X_1$ ,  $X_2$ , and  $X_3$  towards  $Y$  and the influence to  $Z$ .

The calculations of path analysis using inter variables causal effect decomposition model will result in direct causal effects, indirect causal effects and total causal effects. The t-statistic test will be performed in order to test the hypothesis  $H_0$  (the independent variable not significantly influence the dependent variable) and  $H_a$  (independent variable significantly influence the dependent variable). According to Ghazali (2012) if T statistics  $> 1.96$   $H_0$  is rejected and  $H_a$  is accepted and if T statistics  $< 1.96$  thus  $H_0$  is accepted and  $H_a$  is rejected. Next step is to examine the coefficient of determination, denoted  $R^2$  or  $r^2$  and pronounced R squared, is a number that indicates how well data fit a statistical model — sometimes simply a line or a curve. An  $R^2$  of 1 indicates that the regression line perfectly fits the data, while an  $R^2$  of 0 indicates that the line does not fit the data at all.

## 5. Results and Discussion

The data for the purpose of this study was taken from middle to large scale family industries in the Surabaya, Mojokerto, Sidoarjo, Pasuruan and Gresik area with indicators of having over 20 employees and which has experienced the succession process at least once. In total, data from 73 companies were used for this research.

There are a few ways to categorize the respondents used for this study. Based on the number of successions, most of the respondents interviewed (58.14%) have only went through one succession, while 32.56% had experienced succession twice. Based on company lifetime, companies that have been established 30-39 years make up 32.56% of the collected data, followed by 10-19 years with 23.26%, 20-29 years with 18.60% and 40-49 years making up 16.28% of the data. Based on position within the company, 48.83% of the respondents take up the position of Director within their companies, while those who are Owners and Managers of the company each make up 18.60% of the data.

Table 1 Characteristic of Respondents

Number of Successions	Company Type				Total	%
	Trade	Industry	Service	Property		
1	6	7	9	3	25	58,14
2	3	5	6	-	14	32,56
3	1	1	1	-	3	6,98
4	-	1	-	-	1	2,32
<b>Total</b>	<b>10</b>	<b>14</b>	<b>16</b>	<b>3</b>	<b>43</b>	<b>100</b>
Company Lifetime	Company Type				Total	%
	Trade	Industry	Service	Property		
0-9	-	-	1	-	1	2.32
10-19	-	2	7	1	10	23.26
20-29	3	1	3	1	8	18.60
30-39	5	5	3	1	14	32.56
40-49	1	4	2	-	7	16.28
60-69	-	1	-	-	1	2.32
70-79	1	-	-	-	1	2.32
90-99	-	1	-	-	1	2.32
<b>Total</b>	<b>10</b>	<b>14</b>	<b>16</b>	<b>3</b>	<b>43</b>	<b>100</b>
Position	Company Type				Total	%
	Trade	Industry	Service	Property		
Director	5	9	6	1	21	48.83
Commissioner	1	2	-	-	3	6.98
Manager	1	-	5	2	8	18.60
Other	-	1	2	-	3	6.98
Owner	3	2	3	-	8	18.60
<b>Total</b>	<b>10</b>	<b>14</b>	<b>16</b>	<b>3</b>	<b>43</b>	<b>100</b>

To make sure all the variables used in this study are accurate, we apply the validity and reliability test. From the validity test using the Pearson bivariate correlation method, it is found that all indicators from variables X1, X2, X3, Y and Z are valid.

The reliability test is also done to measure how reliable the indicators are when measuring large samples of data using the Chronbach's Alpha method. From the reliability test on X1, we found that variables B1 and B3 are not reliable and will not be used for this paper. The test on X2 shows that variable B6 is not reliable, while variables B8 and B9 are reliable and will be used. For X3, all variables B10-B18 are reliable. For Y, variables C1-C3 are reliable, while C4 is not. Last for Z, variables D1, D3, D4 and D5 are reliable and is valid for use for this paper.

After the reliability and validity test, a path analysis is done to evaluate the direct relationships between the variables. Planning of Succession (X1), Preparation of the Successor (X2), and Relationships between Family Members (X3) is discovered to be directly related to the succession process (Y). The succession process (Y) is directly related to Business Performance (Z). By looking at the coefficients of the path analysis diagram, we can draw conclusions whether the variables are closely related (with T-statistics of  $> 1.96$ ) or not closely related (T-statistics of  $< 1.96$ ).

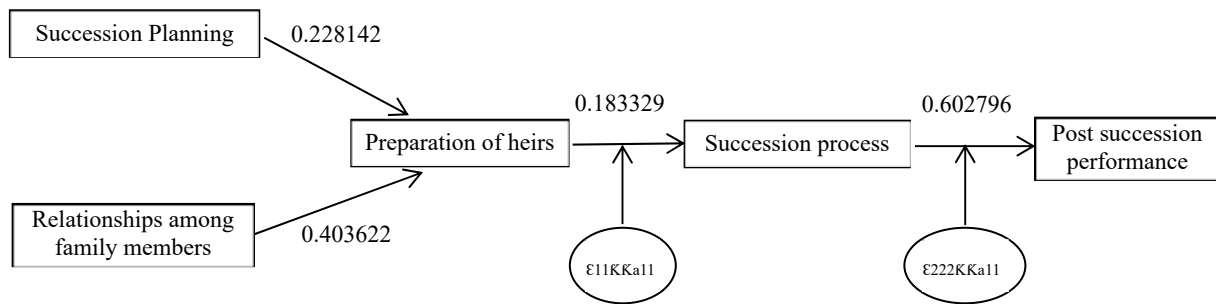


Figure 2 Path Analysis Diagram

In this case, the variable for Succession Planning (X1) is not significantly related to the Succession Process (Y) because it has a T-statistic of 1.178232 ( $< 1.96$ ). However, a positive original sample value of 0.228142 shows that Succession Planning still has a positive influence towards the succession process. A proof that can be seen is that business owners from around East Java have not considered hiring consultants to help them prepare for the succession process. Therefore, there are no strict rules in place regarding the succession process of their businesses.

Likewise, the variable for Preparation of the heirs (X2) does not have a major influence toward the succession process (Y) as it has a T-statistic of 0.984663 ( $< 1.96$ ), but a positive original sample value of 0.183329 still makes it have a positive influence for a successful transition. From the responses received the level of education of the successors is not vital in ensuring success. Rather, getting the right guidance and management advice from their predecessors is much more important for the successors during the takeover period.

On the other hand, Relationships among Family Members (X3) has a considerable influence toward the succession process (Y) with a T-statistic of 2.961620 ( $> 1.96$ ) and a positive original sample value of 0.403622. A majority of respondents agreed that a friendly and open relationship among family members, along with the unified support from all family members is vital for the success of a family business succession. In addition, organizing meetings from time to time with all family members involved in the business is important to keep everyone aware of the current business situation.

Finally, the succession process (Y) also has a tight correlation with post succession Business Performance (Z) with a T-statistic of 6.46779 ( $> 1.96$ ) and a positive relationship with an original sample value of 0.602796. The success of a family business post succession can be measured by how the previous generation ownership is able to smoothly hand over the duty and responsibility of leadership to their successors, as according to what has been planned beforehand.

Table 2 Path Coefficient Result of Path Analysis

	Original sample (O)	Sample mean (M)	Standard deviation (STDEV)	Standard error (STERR)	T statistics ( O/STERR )
Family Relationships (X3) -> Succession Process (Y)	0.403622	0.383294	0.136284	0.136284	2.961620
Succession Process (Y) -> Business Performance (Z)	0.602796	0.595257	0.093200	0.093200	6.467779
Preparation of heirs (X2) -> Succession Process (Y)	0.183329	0.192469	0.186184	0.186184	0.984663
Succession Planning (X1) -> Succession Process (Y)	0.228142	0.241250	0.193631	0.193631	1.178232

Through the R square method, it is found that the variables of Succession Planning, Preparation of heirs and Relationships among Family Members (X<sub>1</sub>, X<sub>2</sub> and X<sub>3</sub>) make up 49.51% of the main components for the succession process (Y) while the other 51.49% are made up of variables that are not identified in this paper. Using the same method, the succession process (Y) is found to have an influence towards Business Performance (Z) by 36.34%, with the other 63.66% coming from other factors not discussed in this paper.

From there, we identify the direct and indirect effects for each variable. The direct effects of the variables X to Y and Y to Z are found from the path analysis coefficients. The indirect effects of variables X to Z (via Y) can be calculated by multiplying the values for each X variable by the value of the Y variable. The total effect towards Z for each variable, then, is just the direct effect and indirect effect added together. The total effect for each variable towards Business Performance can be seen from the Table 3.

**Table 3 Total Effect of Path Analysis**

	<i>Direct Effect</i>		<i>Indirect Effect</i>	<i>Total effect (Z)</i>
	Succession process (Y)	Business performance (Z)	Business performance (Z)	
Succession Planning (X <sub>1</sub> )	0.228142	-	0.146661	0.374803
Preparation of Heirs (X <sub>2</sub> )	0.183329	-	0.110510	0.293839
Relationships among Family Members (X <sub>3</sub> )	0.403622	-	0.243301	0.646923
Succession Process (Y)	-	0.602796	-	0.602796

There are a few limitations that can be pointed out from the results of the study above. First is the size of the sample population used, which is comparatively small. Some of the data received were not valid as different companies were experiencing various parts of the succession process. Because of the difficulty to find viable interviewees, the researcher had to interview some companies that have yet to complete a full succession. Second is the inability of the respondents to answer the questions accurately. The main reason for this is that family business owners tend to keep the details of their succession process a family secret. Some of the questions, however general, may be considered as too sensitive to be answered accurately by the interviewees. Lastly, the limited time that was allocated to data collection caused some of the data to not be received on time for the purposes of this study.

## 6. Conclusion

Succession Planning (X<sub>1</sub>) has a positive influence but is not significantly related to the Succession Process (Y). One of the major factors contributing to this is due to the majority of sample size or up to 93% being relatively new family businesses established under 50 years ago, and only 58% of the entire sample having gone through only 1 succession. In this case, this first succession process only involves a few members of the inner family circle and almost occurs naturally. This also reflects the study from Wang et al. (2004) where the succession process does not significantly affect business performance for small-scale family industries. However, as the company grows bigger and more family members are involved, a more systematic approach is needed in preparation for the succession process in the form of educating and mentoring.

Healthy relationships among family members in the form of continued support, open communication, clear division of roles and responsibilities and effective conflict resolution strategies can do wonders to ensure the success of a succession process and improve business performance in the post-succession period.

The wide scope of respondents used in this study causes the data to be more spread out, reducing the reliability in some areas. The variety of respondents include businesses from trading, services, industries and real estate with some only being established 10 years to others who have been in business for 100 years.

One of the greatest challenges in running a family business is the discipline to follow rules that have been agreed upon, especially among family members due to the intimate nature of the relationship. Being overly tolerant and giving special treatment to members of the family will provide a negative effect in the long run. Things will be different if the same regulations are carried out by professionals. As a result, hiring professionals to operate in the management of the family business is a great solution to solve internal conflicts, provide outside opinion and provide an overall balance for the company after succession.

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