

RESEARCH NOTES AND COMMENTARIES

CEO FOUNDER STATUS AND FIRM FINANCIAL PERFORMANCE

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Founders create their organizations, yet are often expected to eventually become liabilities to these same organizations. Past empirical research on the relationship between CEO founder status (i.e., is the CEO also the founder?) and firm performance has yielded inconsistent results. This study of 94 founder- and nonfounder-managed firms finds that founder management has no main effect on stock returns over a 3-year holding period, but that firm size and firm age moderate the CEO founder status–firm performance relationship. Copyright © 2000 John Wiley & Sons, Ltd.

In recent years, several research studies have examined whether firms managed by the CEOs who founded them tend to perform differently than firms managed by nonfounder CEOs (Daily and Dalton, 1992; Begley, 1995; Willard, Krueger, and Feeser, 1992). The findings of these studies have been inconsistent. Differences in the sample characteristics of these studies could potentially explain some of the inconsistency in the findings, particularly when considered in conjunction with what life cycle theory might suggest about when a founder CEO's presence will likely contribute to or detract from firm performance.

The research described here was designed to potentially reconcile the inconsistencies of past research findings by testing the possibility that

the value of founder management will differ across firms that vary by size and age. In particular, this study examined the following research questions:

Research question 1: Do firms with founding CEOs perform any differently, in general, than those without such CEOs?

Research question 2: Does firm size moderate the relationship between CEO founder status—that is, whether the CEO is also the firm's founder—and firm financial performance?

Research question 3: Does firm age moderate the relationship between CEO founder status and firm financial performance?

Key words: CEO; founder; firm performance

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The following Theoretical Background section presents the basis for the research as well as the hypotheses. This is followed by a description of

the sample, measures, and analytical techniques in the Methods section. The findings of the research are presented in the Results section. Finally, the Discussion and Conclusion section details the implications and limitations of the research, and it identifies promising directions for future research.

THEORETICAL BACKGROUND

The value of founder management

Several studies have compared the financial performance of founder- and nonfounder-managed firms. Daily and Dalton (1992), for example, found no difference in financial performance, as measured by return on equity and return on assets, between small founder-managed and other nonfounder-managed firms. Willard *et al.* (1992), likewise, found no significant difference in performance, assessed using 11 accounting- and market-based measures, between fast-growing companies that were founder-managed vs. 'professionally' (i.e., nonfounder) managed. Denis and Denis (1994) examined the relationship between firm financial performance and majority stock ownership by the firm's CEO. Such ownership is highly correlated with whether or not the firm is managed by its founder (Willard *et al.*, 1992). Using accounting measures of performance, they found no evidence that majority-owned firms perform differently than firms with widely diffused ownership. On the other hand, Begley (1995) observed that founder-managed firms tend to have a higher return on assets than other firms. In short, prior studies that have directly or indirectly assessed the value of founder management have yielded contradictory and noncumulative results. It is, therefore, particularly important to try to understand what theoretical arguments can be made regarding the likely value of founder management.

There are numerous reasons why one might expect that founder CEOs will often possess skills and face incentives that translate into firm performance superior to that commonly attained by nonfounder CEOs. For example, founders may be generally superior CEOs because they highly value their reputational stake in the firm and, hence, exert a greater effort than nonfounder CEOs to ensure firm success. Founders also tend to own a significant fraction of their firm's equity. Significant equity ownership on the part of corporate managers can serve as an effective mechanism for reducing princi-

pal-agent conflicts of interest. Specifically, since their personal fortunes are often tied to those of their firms, founder CEOs may be especially likely to work diligently and/or invest in developing their managerial skills. The effect of this situation could be superior firm performance.

Moreover, a ready willingness to undertake risks and a high need for achievement are characteristics that one might expect to generate and sustain superior performance over time. Tentative evidence suggests that these characteristics may be higher among founder- than nonfounder CEOs (Begley, 1995; Chandler and Jansen, 1992). Finally, entrepreneurs tend to create businesses in industries where they have managerial experience, and this experience may give founder-managed firms a performance advantage over nonfounder-managed firms (Duchesneau and Gartner, 1990).

On the other hand, it is possible to conceive of scenarios under which founder management could be detrimental to the performance of firms. For example, to the extent that a founder's interests diverge from those of the firm's other shareholders and manifest themselves in the form of excessive perquisite consumption, poor performance may result (Jensen and Meckling, 1976). Similarly, in their desire to retain control over corporate affairs and resources, founder CEOs may be particularly likely to refrain from adopting liberal cash payout or dividend policies—an action that could reduce the firm's market value.

On the whole, it is entirely conceivable that CEO founder status may affect firm financial performance. Nonetheless, as the preceding arguments indicate, the likely direction of the potential effect of CEO founder status on firm financial performance is less than clear. Fortunately, arguments based on life cycle theory and research offer the possibility of clarifying the organizational conditions under which a CEO founder's influence on firm performance might be expected to vary. Such arguments are presented below.

The impact of firm size on the value of founder management

A founder's ongoing involvement in general management activities may be decreasingly valuable or even detrimental to a company's success as the firm grows. It is well documented that founders often have difficulty handing over the reins of their company to individuals whose skills may

be better suited to managing large firms (e.g., Flamholtz, 1986; Adizes, 1989). As organizations grow, the entrepreneurial challenge of establishing firm viability becomes less significant and the administrative challenge associated with managing large, complex organizational systems increases in significance (Tushman and Romanelli, 1985). Different skills are needed to effectively manage the entrepreneurial and administrative challenges, and it is a rare individual who possesses all skills needed to grow a business from its inception to a state of maturity where a complex organizational architecture is typically required (Stevenson and Jarillo, 1990).

Consistent with the preceding points, many founders whose skills well match the entrepreneurial challenge may be unable to develop the new administrative skills needed to effectively manage in a large organizational context, or these founders may not perceive that their entrepreneurial skills are any less valuable than they were when their organizations were smaller (Willard *et al.*, 1992). In either case, the value likely to be added by the founder will not be as great as when the firm was smaller, and the founder's continued management may, in fact, represent a hindrance to firm performance. These observations support the following hypothesis.

Hypothesis 1: The impact of founder management on financial performance is more positive for smaller firms than larger firms.

The impact of firm age on the value of founder management

The age of the firm may be another potential moderator of the financial value generated by founder managers. Specifically, in a young organization the opportunities for executive-level involvement in activities across the organizational hierarchy are numerous and varied. Certainly founder CEOs will characteristically be highly involved in most, if not all, significant aspects of their organizations' functioning. As organizations age, routines, systems, and standard operating procedures are consciously created or otherwise emerge (Blau and Scott, 1962). A result of this developing organizational architecture is that senior managers will have less need to become involved in operating decisions, or even all strategic decisions, since various aspects of structure,

broadly defined, will now be substituting for their managerial discretion (Mintzberg, 1979). Thus, firm age may have the effect of limiting the 'required' involvement of founder CEOs, and one might consequently expect a negative relationship between the strength of the effects of founder management and firm age.

The literature on CEO life cycles also has a bearing on the matter of how firm age may affect the value of founder management. Among firms with founder CEOs, the firm's age is, by definition, the same as the time span of the CEO's tenure. Therefore, Hambrick and Fukutomi's (1991) observations on the relationship between CEO tenure and firm performance are pertinent. Specifically, Hambrick and Fukutomi (1991) argued that a CEO's tenure can be described in terms of various 'seasons,' each with its own challenges and demands on the CEO. In the early seasons of a CEO's tenure, the CEO's task knowledge was argued to be accumulating, and his or her most positive effects on firm performance would not yet be felt. Hambrick and Fukutomi (1991) theorized that CEOs would have their most positive impact in firm performance during the intermediate seasons due to this being the era of their highest task knowledge and interest. During the final seasons of a CEO's tenure, '[j]ob mastery gives way to boredom; exhilaration to fatigue; strategizing to habituation' (Hambrick and Fukutomi, 1991: 731), and firm performance declines. In short, Hambrick and Fukutomi (1991) posited an inverse U-shaped relationship between tenure and firm performance among CEOs whose tenures span a long time.

A relationship between CEO tenure and firm performance has been documented by empirical research. While his research does not support the aforementioned inverse U-shaped relationship between CEO tenure and firm performance, Miller (1991) did find a negative, albeit indirect relationship between CEO tenure and several dimensions of firm financial performance. In his study of the CEOs of 95 small and medium-size firms, Miller observed that long-tenured CEOs (operationally defined as those serving more than 10 years), for reasons of paradigm inertia, belief immutability, mental stagnation, and the like, are less likely than short-tenured CEOs (those serving less than 10 years) to create and maintain an effective alignment between their firms' strategy characteristics and environmental attributes. It is this poor

strategy–environment match that directly results in poor performance.

Given the aforementioned equivalence of CEO tenure and firm age among founder-managed firms, Miller's (1991) findings, in conjunction with the preceding observations, support the following hypothesis:

Hypothesis 2: The impact of founder management on financial performance is more positive for younger firms than older firms.

METHODS

Data

The sample of founder-managed firms was constructed by selecting all firms in *Forbes* magazine's annual CEO compensation report that classified the CEO as the firm's founder. The *Forbes* report was deemed a suitable place from which data could be drawn because it identifies both founder- and nonfounder-managed firms. The *Forbes* report is composed of the U.S. public corporations with the 800 most highly paid executives. Thus, there is a compensation-based bias inherent to the sample. The potential relevance of this fact will be discussed later. Given that public firms with the highest paid executives will likely be larger firms, there is also a (large) size-related bias in the sample. This latter sample characteristic is not so much a limitation as a point to be noted. It may even be construed as a positive inasmuch as Miller (1991) has called for replication of his CEO tenure–firm performance research, which yielded results consistent with Hypothesis 2, using samples of large firms.

The 1980–91 period was used to construct the sample of founder-managed firms. Since firms may appear on the list for several years over the sample period, the first year a firm appeared was used as the starting point for performance comparisons. A control sample of nonfounder-managed firms was then formed by selecting for each founder-managed firm a matched firm that (1) was also listed in the *Forbes* report over the same period for which the founder-managed firm was listed, (2) was in the same industry (as measured by 3-digit SIC code) as the founder-managed firm, and (3) was closest in size (market capitalization) to the founder-managed firm

among those firms that met the two preceding criteria.

Based on the above criteria, the final sample consists of 47 founder firms and the same number of control firms, resulting in a total sample of 94 firms. Stock return and market capitalization data were obtained from the Center for Research in Security Prices (CRSP) NYSE/AMEX and NASDAQ data files. Data on the year of the firm's incorporation, used to compute the firm age variable, were gathered from *Moody's* industrial manuals, *Moody's* bank manuals, and *Moody's* OTC manuals.

Measuring long-term performance

A stock performance measure was used as the financial performance indicator in the current study. The stock market valuation of a firm is the present value of future expected cash flows to its shareholders. A stock-based performance measure was chosen for several reasons. First, unlike performance measures based on accounting data, stock-based performance measures are not influenced by firm-specific financial reporting rules. Second, the use of a stock-based performance measure is consistent with an important principle in corporate finance—that is, a firm's manager should act in order to maximize the market value of the firm. Finally, an inherent advantage of using stock market data in performance comparisons is that they provide an explicit means for controlling for differences in risk, since investors will assign a lower present value to risky cash flows. This is important in light of prior research which suggests that entrepreneurs, i.e., founder managers, tend to assume more risk than other managers (Begley, 1995). In fact, many researchers have asserted that risk bearing is the defining element of entrepreneurial character (McClelland, 1961; Timmons, 1978; Welsh and White, 1981). To the extent that managerial risk taking translates into greater financial risk for the firm's shareholders, it is important to measure firm performance after controlling for risk.

Following the methodology of Ritter (1991), a 3-year period was used as the time horizon over which performance was measured. Specifically, 3-year holding period returns, HPR_i , were computed for each firm by compounding monthly stock returns as follows:

$$HPR_i = \left[\prod_{t=1}^{36} (1 + r_{it}) \right] - 1 \quad (1)$$

where r_{it} is the return on the stock of firm i in month t . The holding period return represents the return on a hypothetical \$1 investment in the firm's stock at the beginning of the 3-year period. The 3-year performance measurement period followed the first instance of the founder-managed firm's inclusion on the *Forbes* list during the 1980–91 data collection years.

Explaining the cross-sectional variation in performance

To explore the potential variation in performance of the founder-managed and industry-matched control firms, and to test the research hypotheses, firm-specific factors including firm size, age, and financial risk (i.e., equity beta) were controlled for in a cross-sectional regression framework. To test the possibility that founder-managed firms may generally perform differently than nonfounder-managed firms, the following regression specification was run for the combined sample of founder-managed and control firms:

$$\text{RETURN}_i = b_0 + b_1 \ln(\text{MktCap}_i) + b_2 \ln(\text{Age}_i) + b_3 \beta_i + b_4 \text{FDum}_i + \epsilon_i$$

where RETURN_i is the 3-year holding period return for firm i ; $\ln(\text{MktCap}_i)$ is the natural logarithm of the firm's market capitalization (i.e., the firm size variable); $\ln(\text{Age}_i)$ is the natural logarithm of the difference between the year firm i enters the sample and the year of the firm's incorporation (i.e., the firm age variable); β_i is the firm's equity beta (i.e., the firm financial risk variable); and FDum_i is an indicator variable (of CEO founder status) that is set to 1 for founder-managed firms and 0 for nonfounder-managed control firms. Hypothesis 1 was tested by adding the cross-product of CEO founder status (FDum_i) and firm size ($\ln(\text{MktCap}_i)$) to the above equation, then examining whether this interaction term significantly improved the predictive power of the regression equation. Similarly, Hypothesis 2 was tested by adding the cross-product of CEO founder status (FDum_i) and firm age ($\ln(\text{Age}_i)$) to the above equation, then assessing this variable's predictive power. To support Hypotheses 1 and 2, the regression coefficients for the relevant interaction

terms would have to be negative and statistically significant.

RESULTS

The characteristics of founder-managed and control firms

Table 1 shows comparative descriptive data for the subsamples of founder-managed and control firms, including data on firm size (market value of equity in \$ millions), firm age (years), equity beta (financial risk), and 36-month holding period stock returns. p -values are reported for the equality of means t -test.

Table 1 reveals that the founder-managed firms in the sample tend to be younger, on average, than the industry-matched control firms, with the mean age of these firms being 15.40 years and 29.40 years, respectively ($p < 0.01$). The founder-managed firms are also smaller, on average, than the control firms, with mean market capitalization figures of \$559 million and \$1038 million, respectively ($p < 0.01$). These results are consistent with Begley's (1995) finding that founders tend to run younger and smaller companies than non-founders.

Differences were also observed with respect to financial risk for the two subgroups of firms. Specifically, Table 1 reports that the founder-managed firms have higher equity betas, indicating greater financial risk, than the control firms. The mean values are 1.18 and 1.04, respectively ($p < 0.05$). Although the construct of firm financial risk is not perfectly analogous to the construct of managerial risk, one could make the argument that managerial risk taking will often result in greater firm financial risk. Therefore, the higher equity betas of founder-managed firms could be argued to be consistent with the position that risk taking is inherent to entrepreneurial behavior.

The holding period stock returns are also higher ($p < 0.05$) for the founder-managed firms than for the control firms, the mean values being 1.79 and 0.85, respectively. This result should *not* be interpreted as supportive of the proposition that performance differences generally exist between founder- and nonfounder-managed firms since firm-specific factors (like the size, age, and financial risk differences of the two subgroups) should be controlled before any such conclusion

Table 1. Descriptive statistics for founder-managed and control firms

	Founder-managed firms				Control firms				Significance of <i>t</i> -test <i>p</i> -value
	Mean	S.D.	Min.	Max	Mean	S.D.	Min.	Max	
Firm size (\$ millions)	559	517	35	2797	1038	1040	49	4221	0.00
Firm age (years)	15.40	9.23	2	52	29.40	21.89	3	86	0.00
Beta (equity risk)	1.18	0.49	0.20	2.20	1.04	0.50	0.26	2.27	0.04
Holding period stock returns	1.79	2.54	-0.70	12.27	0.85	1.24	-0.50	5.82	0.02

can be drawn.

Table 2 shows the zero-order correlations among the research variables. On the whole, the correlations among the variables are in the minimal-to-modest range, the single exception being the *r* of -0.465 for the relationship between Holding Period Stock Returns and Log of Size. Importantly, the correlations suggest that multicollinearity need not be a significant concern with respect to data analysis.

Performance comparisons of founder-managed vs. control firms

Table 3 shows the results of the regression analyses performed to test the research hypotheses.

Model 1 reveals that the CEO founder status dummy variable does not contribute to holding period returns after controlling for the firm-specific effects of firm size, age, and equity risk. In other words, there is not a main effect which suggests that founder CEOs add significantly more (or less) value to their firms' stock returns than do nonfounder CEOs.

Hypothesis 1 is supported by the data at the $p < 0.05$ level. Specifically, Model 2 reveals that the inclusion of the cross-product of the CEO founder status dummy variable and the log of size adds significantly to the predictive power of the regression equation, and the sign of the cross-product term is in the (negative) direction implied by the hypothesis. Thus, the impact of founder

Table 2. Zero-order correlation matrix (*p*-value), $n = 94$

	1	2	3	4	5
1. Holding period Stock returns	1.0				
2. Log of size (\$ millions)	-0.465 (0.000)	1.0			
3. Log of age (years)	-0.238 (0.021)	0.289 (0.005)	1.0		
4. Beta (equity risk)	0.026 (0.807)	0.042 (0.681)	-0.108 (0.300)	1.0	
5. CEO founder status dummy	0.230 (0.026)	-0.258 (0.012)	-0.290 (0.005)	0.143 (0.169)	1.0

Table 3. Regression analysis results (dependent variable is holding period stock returns for 36 months)

Independent variable	Model 1	Model 2	Model 3
Intercept	6.925** (4.895)	4.356* (2.495)	6.152** (4.225)
Log of size (\$ millions)	-0.843** (-4.206)	-0.416 (-1.575)	-0.858** (-4.336)
Log of age (years)	-0.230 (-0.887)	-0.302 (-1.189)	0.059 (0.197)
Beta (equity risk)	0.084 (0.217)	0.1087 (0.287)	0.077 (0.203)
CEO founder status dummy (0 = not founder, 1 = founder)	0.383 (0.946)	6.031* (2.522)	3.162* (2.039)
Dummy * Log of size		-0.917* (-2.395)	
Dummy * Log of age			-1.027† (-1.855)
N	94	94	94
Adjusted R ²	0.20	0.24	0.22
F-value	6.92	6.97	6.37
p-value	0.001	0.001	0.001

† $p < 0.10$; * $p < 0.05$; ** $p < 0.01$

Unstandardized regression coefficients are reported because, unlike standardized regression coefficients, they are not affected by the points of origin of the independent variables. See Southwood (1978) for details.

management on firm stock performance is more positive among smaller than larger firms. (As a side note, similar statistically significant results were found when an alternative measure of firm size—number of employees—was used in the analysis.)

Hypothesis 2 is supported by the data at the $p < 0.10$ level.¹ Model 3 shows that the cross-product of the CEO founder status dummy variable and the log of age adds to the predictive power of the regression equation, albeit at a modest level. Consistent with Hypothesis 2, the negative regression coefficient of the cross-product term implies that the impact of founder

management on firm stock performance is somewhat more positive among younger than older firms.

Initially, it may seem curious that the CEO's founder status is not significantly related to stock performance, yet founder management has a 'more positive impact' on stock performance among smaller and younger firms than among larger and older firms (i.e., Hypotheses 1 and 2 are supported). However, this situation is explained by the fact that founder management is *positively* related to stock performance among smaller and younger firms and *negatively* related to stock performance among larger and older firms. The directional effects of CEO founder status on firm financial performance can cancel each other out in a heterogeneous sample of firms, resulting in the absence of a main effect as documented in the Daily and Dalton (1992) research, the Willard *et al.* (1992) research, and the current research. Indeed, over the ranges of

¹ A finding based on a statistical significance level of $p < 0.10$ may not be universally regarded as worthy of discussion. Nonetheless, we choose to interpret this result as 'significant' in view of the facts that (1) it is a confirmatory (vs. exploratory) finding that is consistent with the results of prior research and (2) it was identified through the inherently conservative analytical technique of hierarchical moderated regression analysis.

firm size and age observed in the current database, tests for monotonicity (see Gupta and Govindarajan, 1984, for details on the test procedure) revealed that there are inflection points at which the impact of founder management on stock performance changes from positive to negative. Thus, while founder management may have no strong main effect on stock performance, such management can either help or hinder the stock performance of a firm depending on that firm's size and age. In the current data base, monotonicity tests revealed that founder management contributed to stock performance among firms with market capitalization values of less than \$718.38 million and among firms that were less than 21.74 years old. Among larger and older firms, founder management was associated with poorer stock performance.

DISCUSSION AND CONCLUSION

The focus and results of the current research should be of interest to several groups of organizational stakeholders. Financial investors, for example, may benefit from knowing whether or not the firms of founder CEOs generally outperform those of nonfounder CEOs. The market value of founder management also may be of interest to prospective employees of founder-managed firms, who will sometimes receive compensation that is tied to the firms' market performance. Directors sitting on the boards of founder-managed firms may find it difficult to replace a founder as the firm's CEO. Such directors may, therefore, wish to know whether founder CEOs generally serve shareholders well relative to nonfounder CEOs. Finally, the possibility of differential performance between founder- and nonfounder-managed firms may be of interest to the founders themselves for reasons of personal curiosity, succession planning, etc.

The principal theoretical implication of this study is simply one of support for the position that high levels of organizational performance will result when senior managers' skills are well aligned with the demands of their organizational contexts, in this case defined in terms of requirements imposed by the organization's size and age. In other words, this study corroborates the theoretical importance of seeking an effective manager-job fit. A more specific theoretical

implication relates to the diminishing value of founders to their organizations over time. Consistent with the organizational life cycle literature and the stages of growth literature (e.g., Hanks *et al.*, 1993; Covin and Slevin, 1997), founding entrepreneurs face new and different challenges as they grow their organizations, and success at managing the challenges associated with one stage of growth does not guarantee future success.

There are two primary practical implications associated with this research. First, for investors, it is important to neither seek nor avoid investing in a firm simply because it is being led by its founder. Market returns may not be generally predictable using such a simple investment heuristic. Instead, this study underscores the need for investors to try to assess the founder's ability to enhance shareholder value through effective general management practices at different stages of the firm's life cycle.

A second practical implication of this research is that founders should grow their organizations with the expectation in mind that some day, perhaps long before they are ready to retire, they may have to step down from their leadership positions for the good of their companies. This may be—and in fact often is—a hard lesson to act upon for founders with strong emotional attachments to the organizations they were instrumental in building. However, just as the evidence in this paper clearly suggests that founders can add market value to smaller and younger firms, it also suggests that the presence of founder CEOs may generally erode the market value of larger and older firms.

The findings and implications of this research should be considered in light of its limitations. Three limitations are most noteworthy. First, the results are based on a relatively small number of firms: 94 in total. While the sample was composed of a cross-section of firms of different sizes, ages, and operating in different industries, the modest sample size calls for caution when generalizing from the results. Second, the sample was composed of firms whose CEOs are highly paid. Extensive research on the executive pay-firm performance relationship has generally shown that CEO compensation is weakly related to firm financial performance (e.g., Barkema and Gomez-Mejia, 1998; Veliyath, 1999; Gomez-Mejia and Wiseman, 1997), which suggests the absence of an upward or downward performance

bias among the sampled firms. Moreover, an equality of means *t*-test revealed no significance difference ($p > 0.10$) in CEO compensation for the founder-managed and nonfounder-managed subgroups. This suggests the absence of a within-sample compensation bias that might be the basis for some alternative theoretical explanation of the research findings. Nonetheless, the extent to which the current results would hold for a broader population of firms—including those with modestly and moderately paid CEOs—is clearly an empirical issue. Third, and finally, this research explores the phenomenon of founder value as an abstraction that is somewhat removed from actual managerial behaviors. In particular, while this study has identified an empirical link between CEO founder status and stock market returns, this study has not identified the specific managerial actions of CEOs that either bolster or diminish the market value of their firms.

In closing, the current study augments our understanding of the value of founder management. Nonetheless, many interesting research questions remain unanswered. Future researchers may wish to prioritize a few areas for additional study on this topic. For example, as implied above, empirically documenting *how* founder CEOs add value to their firms would be a significant research contribution. An examination of the potential moderating effects of industry context on the relationship between CEO founder status and firm performance might also yield findings with significant theoretical and managerial implications. The types of organization structures and corporate governance systems used by founder- vs. nonfounder-managed firms could be examined as potential predictors of firm success. Finally, large research samples (vs. anecdotal evidence) could be used to study the performance-related antecedents and consequences of the transition from founder to nonfounder management.

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