CONTROL NEEDS IN ITALIAN PRIVATELY HELD FAMILY FIRMS

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ABSTRACT

In the accounting branch of business studies, growing attention has been devoted to the issues of corporate governance. Yet, the meaning of corporate governance itself should be interpreted differently in the specific context of “family” firms, whereas – for instance – the independent controls performed by independent bodies (for instance: the Audit Committee and the independent directors), developed under a model of separation between property and management, may reduce their appeal – since typically the main shareholders already manage and control the operations of the firms. In a broader perspective, though, as previous research as shown, this paper confirms that the need of professional controls / supervision over family firms is all the more relevant given the specific agency problems that family firms face and the importance of other stakeholders different from the owners.

KEY WORDS: Agency theory, Altruism, Audit, Control, Chapter 11, Familiness, family involvement, family influences, Family firms,Governance, Italy, Ownership, family control, Pre-insolvency agreement, Professionalization, SMEs,Stakeholder theory, Supervisory board,Turnaround.

1.1. INTRODUCTION AND RESEARCH QUESTIONS

In a strict shareholders value maximisation perspective the core agency problem should be less relevant in family firms, thanks to the natural alignment of interests of owners and managers, belonging to the same family when not being the same person.
This assumption, traditionally held true by scholars, has been put in question in two ways.
First, research has shown that the family influence on the firm rises specific agency problems, different from those typical for non-family firms.
Second, the maximisation of shareholders value is not seen anymore as the unique goal of business: a broader conception of the purpose of the firm highlights the importance of other stakeholders, such as employees, customers, suppliers, financiers, communities, governmental bodies, political groups, trade associations, and trade unions. Hence, the need for control appears to be all the more relevant in a family business context, especially in the case of privately held family firms, where the worse aspects may prevail over the positive idiosyncrasies.

The aim of this paper is to gather some preliminary evidence on the degree of sophistication of control systems and procedures of privately held firms (where the family business quota is predominant) and the first research questions can be stated as follow:
Is there a control gap in privately held family firms ?
In particular, the research group has chosen to examine data regarding the governance systems of a sample of firms which found themselves in financial distress.

The second research question can be expressed as follows:
Are there any lessons to learn from the failures of the privately held firms included in the sample, in particular in terms of which types of control procedures/bodies could have prevented the failure or at least improved the firm's situation ?
Given this background, this paper is structured as follows: par. 1.2 briefly reviews the most relevant literature on the topic, par. 1.3 describes the current system of corporate governance of privately held firms in Italy, par. 1.4 exposes some data gathered about distressed privately held firms (with a prevalent quota of family firms), par. 1.5 concludes proposing some ideas for possible future development.

1.2. LITERATURE REVIEW

The agency theory dates back to an article published in 1976 (Jensen,&Meckling,1976), which assumed a pure shareholders perspective regarding the goal of the firm. The article, maybe the most cited about business so far, became the foundation of a sort of obsession with shareholders value maximization which now has in fact lost its preeminence (The Economist, 2010).
According to the theory, potential problems arise when a principal (the owner of the business) hires an agent (the manager) for specialized expertise and delegates responsibility to her. Agents cannot be monitored perfectly by the principal, so they may shirk their responsibilities or act in disregard of the principal's goals. The information gap and the misalignment of goals between the two parties results in agency costs,which are the sum of the costs to the principal of monitoring, the costs to the agent of bonding with the principal, and the residual loss due to the disconnect between the principal's interests and agent's decisions.
Defined in these terms the core agency problem apparently vanishes in the family firms context as long as the owner also manages the firm or the owner and the manager belong to the same family. Consequently, the interests of owners and managers are naturally aligned and the need for formal supervision and elaborate governance mechanisms seems to decrease.

This assumption, traditionally held true by scholars, has been partly confirmed by the frequent observation that CEO salaries increase significantly after a nonfamily or non-owner CEO assumes the position (Poza, & Daugherty, 2014).
Other streams of research and evidence, though, put the notion in question in two ways.

First, research has shown that family influence on the firm rises specific agency problems, different from those typical for non-family firms. According to this view (Schulze, Lubatkin, Dino, &Buchholtz, 2001), agency problems can still occurunder conditions of *asymmetric altruism*, a situation where a familyprincipal acts in a manner that benefits a family agent but creates acost to the business. Although altruism can benefit the family firm bycreating trust and commitment among family members, it canalso cause problems due to family members whofree-ride or consume resources at the expense of the family business (Lubatkin, Schulze, Ling, & Dino, 2005).
Second, the maximisation of shareholders value is not seen anymore as the unique goal for a business: a broader conception of the purpose of the firm highlights the importance of other stakeholders, such as employees, customers, suppliers, financiers, communities and governmental bodies (Freeman, 1984).
That is not just an abstract matter but it has relevant practical implications. For example, the importance of the interests of claimholders different from equity holders becomes most relevant when firms suffer of financial distress and a crucial legal issue is to assess the diligence of managers in keeping the worth of the firm's assets and thus maintaining the business capability of paying back its debts.

In the specific family business context, it is the quintessential coincidence of owner and manger that makes the family perceive the firm as its creature, introduces a socio-emotional value of the firm to the owner (Astrachan, &Jaskiewicz, 2008) but at the same time offers a potential incentive to the owner/manager to disregard the legitimate interests of other stakeholders such as: minority shareholders, creditors, employees and the government for tax collection.

1.3. CORPORATE GOVERNANCE OF PRIVATELY HELD FAMILY FIRMS IN ITALY

Italian privately held family firms can adopt a wide variety of corporate governance systems, even if we focus (as we do in this paper) only on the "traditional" model of corporate governance provided by the Italian law for limited companies which comprises typically - as its essential bodies - a Board of directors and a Supervisory Board (we will not consider the one-tier and two-tier models, which are very rarely adopted).
In effect, privately held family firms governance could be represented by, at opposite ends:

a) a single shareholder, a sole director (the shareholder) and no executives;
b) more than one shareholder – who collectively constitute the shareholders meeting – a Board of directors, which could comprise independent and non executive directors, a line of executives, a Supervisory Board, an audit firm, a compliance/audit manager and a body in charge of the anti-bribery system (*Organismo di Vigilanza*ex *D.Lgs n. 231/2001*).

Even though some of the features of corporate governance above mentioned are compulsory by law (for instance: companies which go beyond some accounting parameters shall appoint a Supervisory Board), others can be chosen by the family firm: namely, the presence of independent directors, of the line of executives, of the compliance/audit manager and the anti-bribery supervisor depend on the free choice by the shareholders and directors of the family firms. In this sense, the corporate governance scenario shows in Italy a relevant degree of flexibility; and, consequently, the level and the extent of corporate governance bodies imply a preliminary understanding of their activities.
First, the Board of directors is in charge of (1) the strategic profile of the companies, (2) the attitude towards risks and (3) the company's structure; in detail, it shall:

a) examine and approve the strategic, operational and financial plans of the firms, monitoring periodically their implementation;

b) define the risk profile, in terms of desired nature and level of risks (risk appetite) in a manner consistent with the previously defined strategic objectives;
c) evaluate the adequacy of the organizational, administrative and accounting structure of the firm, in particular with regard to the internal control and risk managementsystems;
e) evaluate the overallperformance of the company, paying particular attention to the information received from the delegated bodies and periodically comparing the results achieved with those planned.

The specific features of the Board of directors, in the context of privately held family firms, constitute a central part of the current debate about corporate governance: apparently, efficient and proactive Boards could foster growth, cooperation and success of family firms; yet the more they act and participate in the operations, the more constricted are the activities of the members of the family (in their threefold role of family members, shareholders and directors). Within the Board of directors, companies can appoint directorswho are “independent”, in the sense that theydo not maintain, directly or indirectly or on behalf of third parties, nor have recently maintained any business relationships with the firm or persons linked to the firm, of such a significance as to influence their autonomous judgement. Independent directors should propose a different perspective, based on their specific skills and background, beneficial as long as these directors should not be driven by economic ties with the firm or persons linked to the firm.

Moreover, being their role to provideexternal opinions inside the Board, their independence is rather important, because they are not involved in the ordinary running of the firm and they are not as affected by the emotional biases as the owners may be.The Supervisory Board (compulsory in some situations and optional in others):
- has to monitor the compliance of the firm’s operations with the law and the adequacy of the organisation of the firm with a specific focus on the administrative and accounting processes;
- in some cases audits the accounts and financial reports of the company.

When the Supervisory Board doesn’t audit the accounts and the audit is required by law an external Auditor or an Audit Firm has to be appointed for that purpose.
Another element of the corporate governance system – which has to be considered carefully, in its development, when looking at the privately held family firms – is the line of executives (e.g., people having managerial authority in an organization).
In effect, the size, the composition and the mutual relationship between the executives and the Board of directors/the sole director contribute to shape how the firm operates in its market, the time and the process of decision-making, and so on: more complex is the business, more articulated should be the line of executives, who are in charge of different activities by means of their specific skills and competencies.

On the contrary, a family firm with a strong involvement of the family in the operations could opt for a small line of managers, in order to accelerate the processes and keep the power inside the family, thus losing the abundance of skills which could be encapsulated in the firms where a good line of executives is established.
The compliance/audit manager shall conduct periodic internal reviews or audits to ensure that compliance procedures are followed. In this sense, the compliance/audit manager assesses compliance and operational risks and develops risk management strategies, disseminating written policies and proceduresrelated to compliance activities.
Compliance procedures and efficiency (and efficacy) of management are elements which experience a mutual and manifold interaction; first, compliance activities could reduce operating costs in the course of

time, could improve efficiency of the processes and maintain a high profile of compliance with laws and regulations; at the same time, secondly, especially during the preliminary foundation of the compliance/audit function, it is unavoidable that processes, informal procedures and relationship inside the family firm could decelerate and become more institutionalized.
Similar conclusions can be reached when examining the anti-bribery body, in charge of a specific supervision against bribery crimes *et similia*: in this latter case, it should be also considered the perimeter of the activities of this body (which are narrower than the activities of the compliance/audit function).

With these premises, the corporate governance structure of privately held family firms offers multiple observation points: in fact, even though their broad architecture is straightforward (the Board of directors defines the operations and manages the risks; independent directors offer autonomous insights; executives detail and realize the operations planned by the Boards; Supervisory Boards, accounting firms, compliance/audit managers and anti-bribery bodies control), there are pro and cons of a complex design of actors of corporate governance, as indicated above.

The pros are *inter alia* the segregation of duties, the specialization of skills by the line of managers, the role of controls in preventing frauds and mitigating the appetite for risk of the Board of directors, the efficacy of independent opinions by competent non executive and independent members of the Board.
At the same time, anectodal evidence and professional experience often highlight the incumbent risk of failure in the current system of external and internal control, partially due to the overlapping of bodies and functions (which either duplicate control activities or do not cover specific areas of control) and the peculiarities of family firms.
Nevertheless, the investigation about the alternative corporate governance systems, in order to find a good compromise between formalization (to a strong and rigid governance model) and flexibility (to a governance system as the one defined “familiar board of directors”), has to be posed by family members.

1.4. SOME EVIDENCE REGARDING DISTRESSED PRIVATELY HELD FAMILY FIRMS

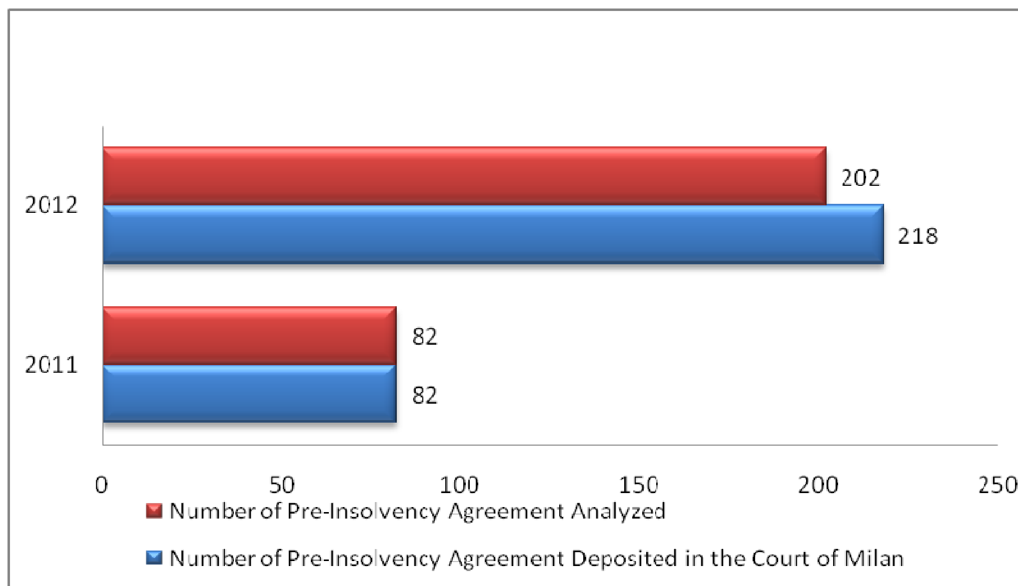
The reform of Italian Bankruptcy and Business Recovery Law was introduced in 2005 and then reviewed more than once (Paluchowski-Pajardi 2008; Riva 2009; Scarso 2009, Quagli-Danovi 2012). It has deeply changed the philosophy and the basics of the country’s business recovery procedures. The new law has introduced tools that are oriented toward the maintenance and recovery of the company by agreements between creditors and entrepreneur, with a greater involvement of the former in the management of the crisis (Corno 2009, Provasi-Riva 2013). To counter the difficulties of the crisis, the government has introduced some specific instruments: Recovery and Resolution Planning (*piano attestato ex art.67 lf*), Restructuring Agreement (*accordo di ristrutturazione ex art. 182 bis*), Pre-insolvency Agreements (*concordatopreventivo ex art. 160 lf*). These techniques form a continuum based on the degree of judicial involvementand the degree of formality in general (Garrido 2011). Ideas to shape them come from the US Chapter 11 tradition (Stanghellini 2007; Gabuardi2007, Riva 2009; Graham-Carmichael 2012) and from United Nations Commission on International Trade Law’s(UNCITRAL’s 2004) Legislative Guide to the Insolvency Law. The focal point is that restructuring can help to preserve the business value of debtor enterprises for the benefit of creditors and other stakeholders. According to the UNCITRAL Legislative Guide (2005)[1], all debtors that falter or experience serious financial difficulties in a competitive marketplace should not necessarily be liquidated; a debtor with a reasonable survival prospect (such as one with a potentially profitable business) should be given the opportunity to demonstrate that there is a greater value (and, by deduction, greater benefit for creditors in the long term) in maintaining the essential business and other component parts of the debtor.

Restructuring and reorganization proceedings are designed to give to the debtor some breathing space to recover from its temporary liquidity difficulties or more permanent over-indebtedness and, as necessary, provide the debtor with an opportunity to restructure its debt and its relations with creditors. If reorganization is possible, generally it will be preferred by creditors if the value derived from the continued operation of the debtor's business will enhance the value of their claims.
In June 2012 a group of Italian researchers from different Universities together with the President of the Bankruptcy Judges of Milan Court started an important research aiming at analyzingPre-insolvency Agreements

procedures (*Art 160 lf)*[1]. The aim is to understand the trends developed in Lombardy major Court from 2007, that is supposed to be representative of the first applications, to nowadays. It is important to say that Milano Court is – together with Rome – the most relevant Italian Court. Each *Art 160 lf* dossier have been analyzed cover to cover. As shown in Chart 1, up to now all 2011 and 2012 dossiers have been processed. This means that 284 dossier representing the entire population of procedures presented in Milano Court in the period considered

have been analyzed. Some of the first research processing and results are presented in the following pages using a preliminary approach as a descriptive analysis.

Chart 1: The Sample – Pre-Insolvency agreement Dossier analyzed



[1]The research has been implemented by: Riva P. (Università del Piemonte Orientale, SAF Scuola di Alta Formazione DottoriCommercialisti Milano), Danovi A. (OCRI Università Bocconi, Università di Bergamo), Bianco C. (SAF Scuola di Alta Formazione DottoriCommercialisti Milano) which are the project directorstogether with La Manna F. (President of the Bakruptcy Judges of Milano Court), Fontana R. (Bankruptcy Judge of Milano Court). The research is independent, not sponsored and has beenimplemented on voluntary basis.

Data (see Chart 2) shows that distressed firms trying to go through a pre-insolvency agreement are directly held by families in 24% of the cases, and that there is a further 64% with concentrated shareholdings which means that it is usually indirectly held by families as well. It is necessary to underline that one of the many ways to define a family firm (Sharma, Chrisman, & Chua, 1996) is a firm whose main direct or indirect shareholder is a family. The analysis on this particular sample can therefore be considered relevant to registerthe presence or the absence of controls in distressed family firms, to study how controls, if existing, are structured and at a second level of the analysis to register if their presence has been substantial in the proactive decision to face insolvency proposing to creditors a pre-insolvency agreement.

Chart 2: Ownership structure

Type of investor	**Percentage**
Concentratedshareholdings	64%
Familyshareholdings	24%
Institutionalinvestors	3%
Diffuse shareholdings	1%
n.a.	8%
	100%

Applications for Pre-insolvency Agreements have been presented by entities structured in 97% of the cases as limited company (see Chart 3). This is coherent with expectations as in partnerships the full personal

responsibility of each person involved can represent an obstacle to a partial composition with creditors and usually leads counterparts to be proactive in applying for bankruptcies.

Chart 3: The legal form – limited companies vs partnerships

Legal form	**Percentage**
Limited companies	97%
Partnerships	3%
	100%

Only 27% (see Chart 4) of the limited companies are public ones, while in the remaining cases they are private. Among these 9% has a sole shareholder; this is linked to the size of entities applying.

Chart 4: The legal form – structure of limited companies

Type of company	**Percentage**
Private limited company	64%
Private limited company with a sole shareholder	9%
Public limited company	27%
	100%

The majority of the companies included in the sample are small or medium sized. The analysis ofthe financial statements presented with the application shows that almost 10% of the companies has registered a turnover higher than 30 million Euros and that almost 60% of the remaining is under the line of 5 million (see Chart 5). Data on number of employees are even more significant as only 2% of the companies enroll more than 200 people, while 70% of the companies enroll up to 50 people (see Chart 6).

Chart 5: Size of firms - Turnover

Turnover Euro'000	**Percentage**
More than 55.000	4,80%
Between 30.000 and 55.000	4,80%
Between 12.500 and 30.000	5,80%
Between 7.500 and 12.500	9,90%
Between 5.000 and 7.500	4,80%
Between 2.500 and 5.000	16,10%
Between 1.250 and 2.500	15,10%
Between 750 and 1.250	9,20%
Between 500 and 750	5,10%
Between 250 and 500	5,50%
No more than 250	10,30%
n.a.	8,60%
	100%

Chart 6: Size of firms – Number of employees

Employees	**Percentage**
More than 200	2,40%
Between 100 and 200	4,10%
Between 50 and 100	5,10%
No more than 50	70,60%
n.a.	17,80%
	100%

It is interesting to see that in 50% of the applications a negative net equity is shown in the last official annual reports (see Chart 7). When the equity is negative the professionals in charge of controls - when appointed as members of the Supervisory Board –are obliged by law to intervene requesting measures by the directors and by the shareholders to manage the financial distress or to liquidate the firm and are therefore expected to have a proactive role in soliciting the solution of the financial distress situation.

Chart 7: Net equity

Net equity	**Percentage**
More than 2.500	10%
Between 750 and 2.500	13%
Between 250 and 750	5%
Between 0 and 250	16%
Net equity < 0	50%
n.a.	6%
	100%

The Corporate Governance model adopted by companies is the traditional one, mentioned above in par. 1.3., chosen in 87% of the situations.When looking at the auditing and accounting control system, the results are shown in Chart 8 below.

Chart 8: The auditing and control system

Type of system	**Compulsory**	**Not Compulsory**
	Percentage	*Percentage*
Supervisory Board with audit functions	59%	14%
Supervisory Board without audit functions & audit firm	23%	3%
Supervisory Board without audit functions & individual auditor	12%	2%
Not present	6%	81%
	100%	100%

The main results from Chart 8 are as follows:

1) even when compulsory by law, the auditing and control system is not present in 6% of the companies included in the sample;
2) when the auditing and control system is compulsory, the majority of family firms appoints a Supervisory Board also with audit functions, which represents a “traditional” and rather basic model of controls;
3) when optional (not compulsory by law), the auditing and control system is rarely established by the firms (only 19%).

All the points above suggest that distressed privately held family firms may face a “control issue” and that a broader adoption of control systems may improve the governance of privately held family firms.

1.5. CONCLUSIONS AND POSSIBLE FUTURE DEVELOPMENTS

The preliminary results shown in par. 1.4. suggest that a control gap in privately held family firms is current in Italy (our first research question), since – even when compulsory – the auditing and accounting control system is not adopted in all the companies of the sample; moreover, when optional, the auditing and accounting control system is poorly spread across family firms. Our second research question (about the failures of current controls and the best mechanisms of control) needs significant further study which is in progress. Future streams of research, in effect, will be devoted (i) to map possible mechanisms of control and (ii) to try to find possible correlations between ownership structure, family influence, control models and their efficacy/failure. Furthermore, especially when looking at the current and fast-changing environment, a call for better competencies and cooperation of directors appear unavoidable; and it will be another possible flow of research to be carried out.

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