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Family effects on management control: the case study of Italian SMEs

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Abstract

This paper provides an empirical study based on SMEs, which are family firms for excellence, about the impact and implications of interaction between the family and the firm on management control. The analysis of management issues is conducted both through the main national and international literature and empirical evidences. The attention is focused on management issues and implications which may be found in Italian SMEs and derived from family management. In particular findings concern the use of management control tools and accounting tools, the methodology of budgeting and economic reporting and the process management.

This study contributes to better understanding the behavior of family managed firms with small and medium size and it underlines characteristics and issues of firms which operate on construction contracts. A study about SMEs is relevant also considering that a lot of studies have focused on large firms and few studies consider the small and medium firms that in Italy, and not only, play an important role in the economy.

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1 Introduction

The aim of this research is to analyze some management issues which characterize the firms considered: Italian small and medium-sized enterprises (SMEs), family managed and working on construction contracts in wiring sector.

This study considers a particular set of family firms: the family firms with small size (Corbetta, 1995) characterized by the correspondence between management and the ownership, how below underlined. It's important to underline that this is not a feature of the whole family firms.

Chenhall (2003), in his survey of contingency-based research on management control systems, points out that only few studies on management control systems include size as a contextual variable. In fact, however SMEs play a vital role in all the world's economies², they have received little attention in literature on management control systems (Ibrahim, Angelidis, Parsa 2008).

These firms are characterized by a particular strategic model as they search a niche positioning and the strategic process is unstructured (Visconti, 2008).

Analyzing these kinds of firms there is another variable to consider as consequence of firm size. This is the management model which characterizes the SMEs and it provides that the entrepreneur assumes all the management responsibilities. Consequently the management corresponds to the owner and this aspect characterizes the family firms.

It's relevant to analyze the impact and the implications of interaction between the family and the firm on management control, underlining the management issues more relevant, also because there are few studies about this topic.

Besides, to better understand the general working of the considered firms, it was analyzed the operative scheme of their structure, identifying some structural characters like³ (Brusa 2004) the management model, the subdivision of labour, the degree and the kind of delegation, the number of structure levels, the presence and the role of some staff.

2 Theoretical Background

It seems simple to define "family business", but when we try to articulate a precise definition it's easy discover that it is a very complicated phenomenon (Hoy - Verser, 1994).

In the literature there is an abundance of definitions and sometimes it also persists ambiguities.

² For example, 99.8% of companies in the European Union and Switzerland have less than 250 employees, and more than twice as many people work in SMEs.

³ This analysis was conducted using contingency approach.

Chua, Sharma, and Chrisman (1996) define family business as a business governed and/or managed on a sustainable, potentially cross-generational, basis to shape and perhaps pursue the formal or implicit vision of the business held by members of the same family or a small number of families.

La Porta (1999) defines family business a firm that is partly owned by one or more family members who together control at least 20% of the total votes outstanding.

Astrachan and Kolenko (1994) suggest that a family had to own over 50 percent of the business in a private company or more than 10 percent of a public company in order to qualify as a family business.

Le Breton-Miller, Miller, and Steier (2004) do not explicitly define a family firm but they assume that management succession means firm leadership will pass from one family member to another or, in the absence of a competent family contender in the short-term, a bridge manager between family tenures.

Zahra, Hayton, and Salvato (2004) define family firms according to the presence of both a family member with some identifiable share of the ownership of the firm and multiple generations of family members in leadership positions within that firm.

Morck and Yeung (2004) use the following criteria of family control to distinguish family firms: (1) the largest group of shareholders in a firm is a specific family, and (2) the stake of that family is greater than either a 10% or 20% control of the voting shares.

Considering all these definitions, it is possible to assert that the SMEs are the family firms for excellence. But the definitions that I share and more appropriate for this study are the following⁴:

- Chua et al. (1999, pag. 25) state: "The family business is a business governed and/or managed with the intention to shape and pursue the vision of the business held by a dominant coalition controlled by members of the same family or a small number of families in a manner that is potentially sustainable across generations of the family or families";

- Anderson and Reeb (2003) define family firms as those in which the founder or a member of his or her family by either blood or marriage is an officer, director, or block holder, either individually or as a group;

- Beehr et al. (1997) state that a family business is one in which two or more family members work;

- Corbetta (1995) identifies a family firm "where one or more families, connected by family or affinity ties or strong alliances, hold a share of risk capital sufficient to ensure control of the enterprise";

- Rosenblatt et al. (1985) define it as any business in which majority ownership or control lies within a single family.

⁴ A researcher can refer to the criteria that is more appropriate for the purpose of the analysis which he wants to conduct (Vigand, 2006).

These definitions include those in which the founder or descendant of the founder is involved in the day-to-day operation of the business and intends for the business to remain in the family (Corbetta, 2005): the main feature of the small size firm.

As already underlined family firms play an important role all over the world. In the year 2000, according to Astrachan and Shanker (2003), even in the United States between 27 % and 62 % of all employees (depending on the definition of a family firm) worked in family firms (see also Zahra and Sharma 2004).

Rather surprisingly with respect to the economic importance of family firms, Dyer (2003, p. 401) refers to the family as “the missing variable in organizational research” and warns that “failing to use the family as a variable in organizational research can lead to incomplete or misleading findings” (Speckbaker G., Wentges P. 2007).

Although the number of papers on family firms has recently increased, few researches analyze the influence of family ownership on management control systems, also if it is evident that the management control system in the SMEs, a particular category of family firms (Corbetta, 1995), is characterized by: i) a control particularly directed to the past (Brusa, 2000); ii) relevance to the tax issues (Tiscini, 2001) and iii) lack of appropriate support tools.

Family business research has concentrated mainly on topics like the economic performance of family firms, succession or the family aspects of such businesses (Speckbaker G., Wentges P. 2007), consequently this study tries to contribute to fill this gap.

3 Research method and research question

The research has been conducted through an *empirical analysis of exploratory multiple case study*. The choice of the multiple case study method is one of the most appropriate way of empirical inquiry because qualitative studies are necessary where organizational processes are involved. Case study research excels at bringing us to an understanding of a complex issue or object and can extend experience or add strength to what is already known through previous research (Yin, 1984, p.23). The case study is defined by researcher Robert K. Yin as an empirical inquiry that investigates a current phenomenon within its real-life context, especially when the boundaries between phenomenon and context are not clearly (Yin, 1984). Strength of the case study method is that the emergent theory is likely to be testable with constructs that can be readily measured and hypotheses that can be proven false. Measurable constructs are likely because they have already been measured during the theory – building process. The resulting hypotheses are likely to be verifiable for the same reason (Huberman, Miles 2002).

The results are based on interviews both with owner and with employees. The interviews were semi-structured to be kept within the main question area but

still open the possibility to get the interviewees own ideas and feelings. The interviews also included some questions to verify the good quality of answers (Yin, 1984).

The interview, as a survey tool, has advantages such as flexibility, nonverbal behavior, environmental control, the order of questions, the completeness, the response from the interested interviewed, but it has also disadvantages such as the costs, the time, the interviewer's influence and a less standardization of the questions formulation.

The main questions discussed during the interviews are the following:

- What is the internal organization and the main functional areas?;
- How are the operative activities divided and how are the responsibility assigned?
- What are the activities delegated?
- In the firm there are some staffs to support the management?
- About the management control what are the management and accounting tools more widespread?
- How does the budgeting and reporting process perform ?
- How are the processes managed?

The firms considered are ten Italian SMEs working on construction contracts in wiring sector random selected, but with revenues higher than 1.000.000 euro.

The choice of ten firms is supported by the Eisenhardt's approach to case study research which argues for the use of more than a single case. She concludes that "between 4 and 10 cases usually works well. With fewer than 4 cases, it is often difficult to generate theory with much complexity, and its empirical grounding is likely to be unconvincing, unless the case has several mini-cases within it"(Eisenhardt's, 1989).

The choice to examine firms that operate in plant engineering sector is also supported by an inquiry which disclosed that, over the last few years, prevalent juridical forms in this sector are those of individual firms and firms with personal character. These juridical forms represent the 90% of the total number of firms operating in this sector and the management model more adopted in these firms is that "where the entrepreneur assume all the government responsibilities of the firm" (Bruni 1990). As a result the owner corresponds with the management and this situation is peculiar of family managed firm.

The research question is focused on the impact and the consequences of two variables, size (in this study, small size) and family, on management control, also considering that these firms work on construction contracts.

4 Findings and empirical evidences

In this paragraph, in addition to the analysis of the family and size effects on management control in the sample analyzed, it follows also the examination of the organizational features of Smes, to better understand this kind of firms. The

managerial implications of findings were analyzed in the next paragraph.

4.1 Organizational features of the analyzed Smes

The considered firms are classifiable as small enterprises. Frequently different criteria are used to identify the SMES: sometimes it is used the turnover, in other cases the number of the employees or the number of products or the market share. In this study, in order to identify a small and medium enterprise, the parameters used are the personnel size and the presence of a management model definable “absolute entrepreneurial” (Bruni 1990, Bertini 1984). It is important to underline that the last parameter is the most relevant for this study. About the personnel size it is possible to affirm that a small firm has an employees’ number not higher than 50 units; the management model adopted provides that the figure of the entrepreneur assumes all the responsibilities of management, consequently the management corresponds to the owner, typical feature in the family firms. This element points out a distinctive organizational character of the firms analyzed: the model of management. In this model, which characterizes the family business, the owner is the subject which takes every kind of decision. Frequently the owner has a technical background, because he worked as a specialist in another firm and after some years of experiences he starts a firm.

Analyzing another organizational character, the subdivision of labour, it was possible to observe as the employees which work in close ties with the owner are frequently related. Generally these subjects carry out a lot of activities, sometimes also not closely tied to the covered role, but normally they do not take managerial roles. They do not take responsibilities for two reasons:

- the presence of the powerfully figure of the owner, which does not allow the emerging of managerial personalities;
- the absence of an employees management system which stimulates behaviors of managerial kind.

Besides it emerged that in these firms the traditional functional areas are not easily identifiable. The functional areas best defined are the Administrative one and the Technical - Production one, while the Commercial Function Area is nearly absorbed by the owner, which holds all the strategic contacts with the customers and potential customers. The Research & Development Function Area is completely absorbed in the Technical - Production Area, just as the Employees Management Function Area in the Administrative one.

Naturally, in coherence with the other organizational characters the degree of delegation is limited. In fact both the decisions inherent the daily management both the strategic ones are taken directly from the owner and consequently the structure is centralized.

In these firms, the number of structure levels, apart from the corporate top management is two. This feature guarantees an elevated flexibility to the firms to

adapt themselves to the external changes and it abbreviates the decisional process.

The last analyzed organizational character concerns the presence of staffs, that in these family firms is absent, except some external consulting, but it is evident the necessity of these organs to support and to free the top from the merely executive and operative activities, in order to dedicate itself to strategic activities.

4.2 The use of management control tools and accounting tools

In the considered family firms, the *management control tools* more used are the ratio analysis and the analysis of the items which compose the financial statement; in particular the attention is focused on taxation issues and on the results more relevant for banks (like net income, aging of credits and debts). In fact for these kinds of firms, undercapitalized, it's important that banks continue to provide credit.

Besides the management accounting is totally absent and the budget is not used. The lack of these tools, which frequently occurs in these enterprises, has causes the increase of some management difficulties more evident with the economic crisis.

4.3 The methodology of budgeting and economic reporting

In the examined firms, the most relevant difficulties referred to management control are tied to the drawing up of estimates and the reporting.

As regards the drawing - up of construction contract estimates it is necessary to underline that generally the full cost of the construction contract is composed by four items:

- Raw Materials;
- Direct Labour;
- Other direct costs;
- Overheads.

If it is easy to identify the top three items, more difficult it is to quantify the overhead costs to charge to the single construction contract.

The criterion adopted by these firms, to cover the overhead costs, is to recharge the direct labour and the raw materials of a prefixed percentage.

This method presents some limitations:

- it is not immediately understandable if the percentage is sufficient to cover overhead expenses and to remunerate the venture capital;
- with this criterion it is difficult to implement any costs containment strategy;
- it is not possible to identify the exact cost of each construction contract with implications for management decisions.

It is important for a firm to know the costs and the consumed resources by

own products, in the specific case by the construction contracts, to implement the management control and to fix a competitive selling price.

To resolve the issues related to the drawing - up of estimates, it is necessary to modify the method adopted. In fact, before to fix the selling price, it is required to clearly define the overall cost of the construction contract.

To do that it is necessary to face up the issue tied the allocation of overhead costs to the single construction contract. The method used is the "hourly rate of annual overhead costs".

This criterion is simple and criticisable, because it is possible that the overhead costs are not properly allocated to construction contract which has consumed the resources. However, this method is acceptable in the cases analyzed and it presents some advantages. An annual allocation coefficient allows a fast calculation of the costs referred to construction contracts, since it must not wait for the monthly survey of overhead costs; the annual calculation require less efforts and in addition, this annual coefficient is not influenced by peculiar conditions of the month⁵ (RN Anthony, 2005).

The general principle of this tool is to assign the overhead costs to each construction contract using an allocation basis, which is usually identified in the critical resource of the firms respecting the causal principle.

For the sample analyzed the allocation basis was identified in the critical resource of the direct labour.

The "hourly rate of annual overhead costs" shows that each hour of direct labour used generates "x" euro in overhead costs; through this method each construction contract will be charged of a "overhead costs" rate, in relation the effective consumption of direct labour.

At this point it is essential to clarify that it would be appropriate to overcome two main limitations of the "hourly rate of annual overhead costs".

The first limit, referred to the rate calculation on an annual basis, is overcoming introducing, apart from the considered rate, an updated rate which takes into consideration both the evolution of costs both the volume of activities in order to prevent any changes in the overhead costs structure. Regarding the second limitation, referred the use of a single criterion for the allocation of costs having different nature, it would be appropriate to identify homogeneous classes of costs and to select an appropriate basis of allocation for each class.

Another key moment in the firm management is the one concerning the reporting, which allows the gathering of information about the results realized to verify that the firm management has been in line with the budget (Brusa 2000).

In the sample analyzed, this phase is not carried out systematically; in fact only few construction contracts are gathered in a report, without an objective criterion for selection. Besides the concurrent control phase of the construction

⁵ for example heating costs in winter months.

contracts is missing; consequently it is not possible to implement corrective actions when the construction contract is carried out, noticing the results, sometimes not positive, only at the end of work. The surveys and the economic control should be carried out steadily and in advancing of construction contracts to collect inefficiencies.

Another issue in the concurrent control phase is related to economic variance due to the economic progress of the construction contract.

It must make homogeneous the data used for the variances analysis, comparing the "costs of actual progress of the construction contract" and the "estimated costs in a definite moment of work in progress" to verify if the costs are in line with budget, noticing positive and negative variance and their causes, before the conclusion of the construction contract. In fact, it is very important the phase concerning the considerations of the possible causes of variances to detect the issues which may determine significant economic impacts. Some reflections follow as example of the possible causes of variances about raw materials:

- if there is a positive variance, and apparently there is a saving in the consumption, however, it must ask if this saving is due because they are not yet acquired the raw materials, or even the raw materials were taken out from store, but not yet charged to the construction contract;
- if the variance is negative, and apparently it is showed a high consumption of resources, it must verify that effectively the raw materials indicated correspond to the actual progress of construction contract and all raw materials were not acquired for the construction of 100% of the construction contract, and therefore already charged.

It is evident how for a company it is not sufficient to read a number, but it needs to understand the meaning and the implication of that number and what factors have influenced it. This requires managerial capabilities, which sometimes lack in these firms.

Furthermore, the analysis showed that, for companies that operate on construction contract, it is crucial a database which contains the report of every construction, an indispensable tool in the planning and in the variance analysis. In fact in the past construction contracts it is possible to identify phases and activities by which the company has an high degree of familiarity and this can facilitates the formulation of estimates.

4.4 Process management difficulties

Analyzing these family firms of small size it emerged as the increasing of business complexity implied coordination problems, especially when it is required the involvement of two or more offices. Consequently it would be appropriate to introduce process management logic, which derives from the conviction that competitiveness is also generated by management by objectives.

In fact in the analyzed firms it tried to highlight the key business processes,

both in order to solve organizational and management problems both for a future and possible adoption of accounting for "activities" (Activity Based Costing).

Through the analysis of the main processes in these companies, the most important problem concerns the lack of procedures formalization, particularly referred at the phase of contract stipulating. With particular attention to the Commercial Process the problem is tied to the change of customers' structure: no more few customers of a single sector, but several customers who belong to different sectors, generating difficulties in managing relationships and an increase in activities within the firms requiring most formalization.

It was considered appropriate, to remedy the problems of low formalization, the identification of processes, differentiating into primary:

- Commercial;
- Production;
- . Supply;

and support:

- Administration;
- Design.

The process analysis is useful not only in terms of organization and management, but as already mentioned, also for a future approach based on accounting "activity" to overcome the limitations of the annually hourly rate of overhead costs. In fact, often there is no direct link between the product and the consumption of certain resources; in a firm there is not only the final product which generates costs, but a lot of intermediate output. Consequently the product may not be the only object of calculation. The product, to be produced and sold, requires the course of activities and also these consume resources and therefore generate costs (Thomas Johnson. H. 1988). Of course also this tool based on activities accounting has limitations mainly related to the complexity, because in order to introduce it in a firm, it need to do a meticulous organizational analysis, which identifies all the activities requiring the use of long time and many resources.

5 Limits

This research presents some limits that can be summarized as follows:

- the analysis was conducted using qualitative data which can be affected by subjectivity;
- the number of firms is limited;
- the study considers two variables, size and family, to evaluate the impact and the consequences on management control, but there are other variable to consider, for example the culture of the management;
- this study considers the family firms with small size, but for future researches it is opportune to consider also other sizes and to compare them.

6 Managerial implications and conclusion

Through this analysis two elements were taken into consideration as variables that act on management control: small size and family management.

In particular, analyzing the organizational features it was possible to underline how the owner conditions the management control system, centralizing everything and basing every decision, strategic or operative, on his knowledge without allowing a rational growth of figures more specialized. Consequently also the management control is based on his knowledge and frequently the lack of competencies and time of the owner do not allow the development of the whole competitive dimensions in the firm. The lack of the development of specific competencies is also due to economic reasons; in fact the professional collaborations are expensive and sometimes not accessible to the small firms.

The presence of the family in the firm management and the small dimension generates the following issues and consequences on management control:

- the absence of the management control tool like the budget;
- about the phase of estimates drawing-up the relevant issue is related to the impossibility to economically evaluate the construction contract, because it is applied a recharge percentage on raw materials and labour to cover fixed costs, but without knowing if that is a fair rate of all inputs' remuneration. Consequently, it was proposed to allocate overhead costs through the hourly rate of annual overhead costs, thus allowing the top to evaluate a construction contract more correctly;
- as regards the process of reporting in the firms examined it emerged that this phase is not carried out systematically and the concurrent economic control is totally absent, although it is clear that these phases are crucial to evaluate the economic convenience of the construction contract in progress, and also to evaluate the convenience of future construction contracts developing a database which contains historical data;
- to resolve some problems lied the interaction of two or more offices and to improve performance in the relations with the customers and the suppliers it is necessary the introduction of process management. Besides this approach tries to overcome some limitations of the accounting tools before proposed. Indeed, introducing an activities accounting it is possible to overcome the limitations of the hourly rate of annual costs, respecting the causal principle in allocating overhead costs, but also to allow the management in the increasingly business complexity, which generates coordination problems . The process management requires a greatest formalization of the activities and consequently a standardization of these, but this ensures greatest protection and quality towards the customer, although if it can overload the work.

When the size is small it's evident that the owner does not feel the need of a management control more depth and accurate, thinking to solve each problems with his presence. Only in a second step of the firm growth also the management

control takes shape and it is delegated to a figure with specific skills.

These issues that point out a poor management and controlling system can cause some critical consequences for this kind of firms:

- in the transition and succession phase it is very difficult to establish the firm value or the potential value, with the risk to close the firm if there is not a strategic plan (Corbetta, 2005);
- it is difficult to take strategic decisions for the long term: how much and in what area to invest, because there is not an evaluation system;
- it is very hard to evaluate the consequences of the taken decisions and eventually to correct them;
- it is complex to begin a rational process of growth;
- it is difficult to understand the management inefficiencies and consequently to eliminated them.

Despite the presented issues the firms family managed and with small size show some advantages like the following:

- the decisional process is very fast, also if there is the problem of the conflict between the different generation (e.g. father and son);
- they are more customer-oriented and quality focused (Ibrahim, Angelidis, Parsa 2008);
- they are more active in the community (Ibrahim, Angelidis, Parsa 2008).

In small and medium firms the management accounting systems are sometimes unapplied or unknown (Lombardi, Stocchetti, 1996) and frequently the attention is focused on administrative, bureaucratic, and taxation issues. Consequently these issues are more important than managerial matters (Vergara, 2004).

Concluding this study is in accord with researchers which affirm that the diffusion of management control systems depends by internal firms characteristics, such as size, complexity, technology, organizational structure, strategy, or internal culture (Chenhall, 2003).

This study also contributes to better understanding the behavior of family managed firms with small size and to analyze the impact of these two variables, size and family, on management control. It also underlines characteristics and issues of firms which operate on construction contracts.

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