Management Control in Family Firms

Comparison of family preferences and control requirements with a control radar

Andreas Oesinghaus, M.Sc. is a research fellow and PhD student at the Chair of Controlling / Performance Management at the University of St. Gallen. Email: andreas.oesinghaus@unisg.ch

Jonah Mostler, B.Sc. is a student at the University of St. Gallen.

Prof. Dr. Klaus Möller holds the Chair of Controlling / Performance Management at the University of St. Gallen as well as Co-Publisher of the magazine Controlling. Email: klaus.moeller@unisg.ch

Intro

Family firms have unique characteristics due to their financial and emotional ties to a family, which influence the design of their control system. This article explores these interactions, providing a systematic basis for controllers and owners to express and align their expectations for the control system. Further, the dominant role of informal controls in family firms is emphasized.

The German version of this article appeared as: Oesinghaus, A., Mostler, J., Möller, K., Steuerung in Familienunternehmen, in: Controlling 36. ed. (2024), No. 2, pp. 10-16.

https://www.beck-elibrary.de/zeitschrift/0935-0381

ZEITSCHRIFT FÜR ERFOLGSORIENTIERTE UNTERNEHMENSSTEUERUNG
CONTROLLING
Herausgegeben von Péter Horváth, Thomas Reichmann, Ulrike Baumöl, Andreas Hoffjan, Klaus Möller, Burkhard Pedell

1. Management Control in Family Firms

The overwhelming majority of companies worldwide are family firms (cf. La Porta, Lopez-De-Silanes, Shleifer, 1999). Contrary to the widespread perception that family firms are mostly smaller enterprises, family firms occupy all size classes and can be both privately held and publicly listed. In contrast to non-family firms, members of the family are involved in at least one of the areas: ownership, management, or control. Due to the financial and emotional commitment of the family, family firms exhibit certain characteristics (cf. Gomez-Mejia et al., 2011). These include, for example, a long-term orientation, a higher appreciation of non-financial factors (cf. Zellweger & Nason, 2008), or a different perspective on risk. In contrast to the usual definition of risk as volatility, risk in family firms is typically understood as vulnerability. Because of these characteristics, management control systems also differ. For instance, the family's values can serve as a reference for management, leading to a more informal and value-based management of the firm.

The following article organizes the existing knowledge on the specific design of management control systems in family businesses into a model. The developed model aims to serve as a checklist for controllers and owners to enable a systematic comparison of expectations and design of the management control system. This allows for a critical reflection of these interactions and the derivation of needs for the management control system. In Section 2, the characteristics of family firms are outlined. Section 3 presents the methodological foundations of the literature analysis, the results of which are highlighted in Section 4. Section 5 concludes with the development of a management control radar for family firms and its use as a recommendation for action.

2. Family Firms Characteristics

Due to the influence of the owner family, family firms exhibit significant differences compared to non-family firms (cf. Anderson & Reeb, 2003; König et al., 2013). These characteristics are highly interdependent and on different abstraction levels.

Owners of family firms are typically fully invested in their business and therefore less diversified. Due to this **concentration of wealth**, there is a significant dependence of the family wealth on the well-being of the firm.

In addition to the financial commitment, there is also a strong **emotional tie** of the family to the family firm. This stems not only from the financial commitment but especially from the often multi-generational relationship with the company, leading to a higher relevance of strategic aspects.

The substantial financial dependence and strong emotional tie create a strong **desire to stay in control** of the family firm. The reluctance of family firms to decentralize (and thus relinquish control) is seen as an indicator that the owner family prefers to retain control (cf. Mahoney, 1992).

Furthermore, the **resources** of family firms are **limited**. This limitation is primarily a result of the desire to stay in control and is expressed in three dimensions: a) financial resources are limited to the family wealth, as raising new capital would reduce the family's influence; b) human resources, especially in upper management, are also limited. Involving external individuals in crucial decision-making processes could diminish the family's control; c) social capital, particularly in terms of resources available through the family's personal network, is limited.

Typically, there is a relatively close relationship of **trust** between the owner family and the management as well as the employees of the family firm. The owner family trusts that the management makes the right decisions in alignment with family interests.

The financial and emotional ties also lead to a higher **risk aversion**, primarily driven by the need to ensure the survival of the business (cf. Anderson & Reeb, 2003).

Due to these financial and emotional ties, family firms also pursue **longer-term goals**. The driver of strategic resource allocations is the long-term survival of the family firm. Consequently, the risk of liquidation is significantly lower.

Moreover, family firms typically exhibit slower adaptation processes. Such "**inertia**" is based on an emotional attachment to existing structures and the goal of preserving the legacy.

The **socio-emotional wealth (SEW)** of the owner family is closely connected to the firm and holds significant value for them. This "preservation of a good name" is often a value in itself, and a loss is associated with reputational damage as well as a loss of status and control. To preserve their good name, families are even willing to risk the financial well-being of the family firm.

Nepotism is also typical for family firms, which involves a preference for hiring and promoting family members without considering their actual qualifications. This can lead to problematic behavior such as opportunism, free-riding, or demotivation of non-family employees.

3. Data and Methodology

To examine the interactions between the characteristics of family firms and their management control system, a systematic literature review was conducted. This involved searching for relevant keywords in various academic databases to identify studies at the intersection of family firms and controlling. Only studies published in high-quality academic journals were considered. Subsequently, the studies were manually reviewed to ensure their relevance. The dataset created through this process comprises 39 studies over a period of 38 years from 28 different academic journals. A list of these studies can be obtained from the authors. It is evident that the interaction between family and management control has been explored over an extended period and from various perspectives through these studies. The insights from these studies form the basis for the development of a management control radar for family firms in Section 5, based on the interactions derived from the characteristics of family firms.

4. Configuration of Management Control

The characteristics of family firms have an impact on their decisions, including the decisions regarding the design of the management control system. Existing empirical insights and the characteristics of family firms are now combined to identify systematic design patterns concerning the management control system and to provide recommendations based on these patterns. The established concept of a management control system as a "package," a combination of various control mechanisms, is used as the reference framework (cf. Malmi & Brown, 2008). Five components are distinguished (Cultural Controls are considered informal, while the remaining four controls are viewed as formal):

- **Planning Controls** involve setting goals to guide resources and steer employee behavior, aligning them with organizational goals (e.g., setting revenue targets, production and material cost budgets, or internal benchmarks).
- **Cybernetic Controls** support goal achievement through systematic measurement and feedback (e.g., through target-actual comparisons, Balanced Scorecards, or OKRs).
- **Reward and Compensation Controls** aim to motivate employees and align their behavior with organizational goals (e.g., through variable compensation models).
- **Administrative Controls** encompass the organization's structure, governance, and policies (e.g., through formal approval processes).
- **Cultural Controls** aim to harmonize the values and behavior of employees (e.g., through training and communication).

The following connects the existing research findings on family firms with these control practices to inspire analyses and derive design recommendations (see also Fig. 1). The effects generally tend to originate from the characteristics and influence control practices. However, the reverse mechanism also occurs: culture-based control practices, for example, contribute to building trust and emotional bonds.

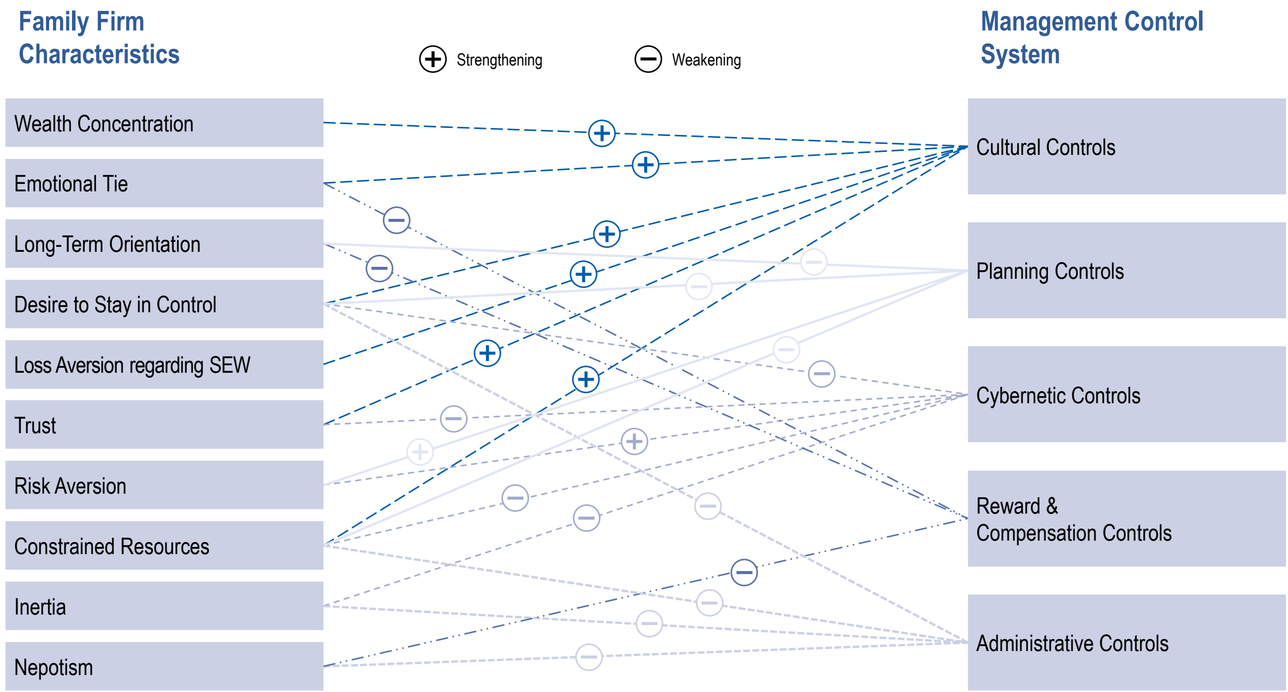

Fig. 1: Interaction between family firm characteristics and the management control system

Cultural Controls

The characteristics of family firms promote the implementation of more informal cultural controls and hinder the implementation of formal controls. Thus, management control systems in family firms are less based on explicit rules, checks, and incentives. Instead, there is a focus on cultural and social relationships (cf. Speckbacher & Wentges, 2012). This is supported by various lines of reasoning:

1. For the strong relationship of trust between the family and employees, management via cultural controls is considered sufficient. The greater this trust, the greater the overlap of interests, and the lower the need to use formal control elements (cf. Stergiou et al., 2013). Additionally, the strong emotional bond supports a focus on non-monetary aspects and thus control through cultural and social components.
2. Due to the concentration of power and wealth within the family, there are no minority shareholders who, out of fear of gradual expropriation, would demand a shift away from a culture-based control and instead advocate for formalization of control (cf. Songini & Gnan, 2015).
3. As a result of the desire to stay in control, the family is hesitant to hire dedicated controllers and external managers who would advance formalization or may be necessary for formalization. The decision-making authority and expertise of these employees could erode the family's influence.

4. Limited resources, especially in terms of human and financial capital, support the use of (cheaper) cultural controls. Formal control processes such as strategic financial and budget planning could otherwise require significant management capacities.
5. Management via cultural controls makes a significant contribution to the socio-emotional wealth of the owner family. Maintaining the family's network, authority, and values is an inherent part of an informal, person-centered management control system. Formalizing control, for example, by replacing a personal feedback discussion with an evaluation form, would restrict this.

Planning Controls

In extreme cases, the desire for control turns strategic planning into a family affair and therefore tends to make it less relevant in the context of the firm. Especially with regard to the market positioning, the geographical footprint and individual product decisions, for example, family owners sometimes exert considerable influence. Due to scarce resources and the longer planning horizon - family businesses tend to think in terms of generations rather than business cycles - annual budgeting also tends to lose importance. On the other hand - and in line with risk aversion - strong planning controls are regularly found in family businesses, particularly evident in a detailed cost planning.

Cybernetic Controls

Cybernetic controls are also less pronounced due to limited resources and the desire to stay in control. OKRs or the Balanced Scorecard are not only a large and lengthy project to introduce, but also tie up a lot of resources during use and are therefore implemented less frequently by family firms. In addition, the hesitation of family firms to use more advanced tools can also be attributed to their inertia and trust in their managers. The reluctance to introduce new cybernetic controls is also based on the belief that the current instruments are still effective due to their historical track record. In addition, the higher level of trust reduces the perceived need for further controls. Risk aversion, on the other hand, prevents change in general, as more advanced instruments are themselves perceived as a risk due to their novelty and change (cf. Giovannoni et al., 2011). However, to adhere to risk aversion, there is usually a more intensive monitoring of costs, often reflected in more frequent budget-to-actual comparisons. In many cases, adherence to communicated targets such as sales, cost or profit targets is monitored very closely.

Reward & Compensation Controls

The emotional bond acts as an additional incentive and strengthens intrinsic motivation for both family members and employees, often compensating for below-average pay (cf. Carrasco-Hernandez

& Sánchez-Marín, 2007). The long-term orientation of family firms also naturally contrasts short-term monetary incentives and limits variable remuneration. If members of the owner family act as managers, the variable remuneration is already present in the form of a share in the family firm.

Administrative Controls

To safeguard the family's influence (in normal and especially in exceptional cases) and to keep financial information confidential, administrative controls are often less pronounced, which is regularly reflected in "weak" or ill-defined controlling departments. The influence of the controlling department is in indirect competition with the owner family's desire to stay in control. Another example of lower administrative controls are unclear or non-existent role descriptions. Family members in particular often have several roles in the family firm. Succession can also lead to ambiguities in roles: If, for example, a daughter of the owner family joins the family firm as a manager, it may be unclear what decision-making and disciplinary powers she has. The role as a manager entails different or fewer competencies than are assumed for a member of the owner family.

Mediators and Moderators

In addition to the direct influence of the characteristics of family firms on the design of the management control system, there are also effects that work indirectly (mediators) or are influenced by a third factor (moderators). Strong family influence, for example, does not directly lead to less formalization of the management control system, but allows it to be designed according to their preferences. Among other things, the owner family's focus on identity and decision-making power act as mediators. If the family is mainly oriented towards the firm and its goals, the control system takes on a central role for the family and tends to be more formalized. If, on the other hand, the focus is more on intra-family goals, control tends to be informal (cf. Leenders & Waarts, 2003). Due to the central role of such factors in shaping management control systems, it is important to talk transparently with the owner family about their priorities. In this way, clarity can be gained about their expectations of the management control system and it can be better designed to meet their needs.

Professionalization of the Management Control System

If a company becomes larger and/or more complex, the need to professionalize the management control system increases to manage the increased complexity. In the literature, professionalization is often equated with a formalization of the management control system. Family firms are regularly faced with the challenge of finding a reasonable transition from a more informal to a professional and therefore more formal management control system. This includes, for example, employing managers who are not members of the owner family, hiring dedicated controllers or decentralizing and delegating control. Professionalization enables a family firm to optimize its financial performance, transfer implicit family knowledge and reduce complexity, e.g. in times of company growth and succession (cf. Leotta et al., 2017). However, this is determined both by the motivation of the owner family and the ability of the family firm (cf. Hiebl & Mayrleitner, 2019). The motivation to professionalize is usually supported by the concentration of wealth, risk aversion and long-term orientation and is a prerequisite for the implementation. The ability to professionalize is then restricted by limited resources and nepotism.

5. Preference-Based Design of the Management Control System

Based on the interdependencies documented in the literature, a structured discussion with the owner family on the design of the management control system can be held. This allows controlling to prevent conflicts (by making them explicit at an early stage if necessary) and address the needs of the family. The degree of detail in the implementation and the degree of involvement of the family is of course very much dependent on the extent to which the family is engaged in the management control system. As a rule, the owner family typically is much "closer" in smaller companies and is involved in the specific design of instruments, whereas in larger companies and with a larger group of owners, the level of involvement is lower. The finance department has a delicate role to play here, namely to implement the necessary management requirements with and potentially even against the wishes of the family. The CFO is, due to their organizational role and liability, obligated to the organization on the one hand, but, of course, also to the owner family on the other. In many cases, the family is directly involved in the selection process, and in many cases there are close personal ties over time. Here it is necessary to act with objectivity and prudence. To support this, the use of a "management control radar for family firms" can be useful, which systematically and holistically compares the requirements for the design of the management control system with the requirements of family firms and initiates a process of critical reflection as a starting point for a structured discussion between (external) management and owner family.

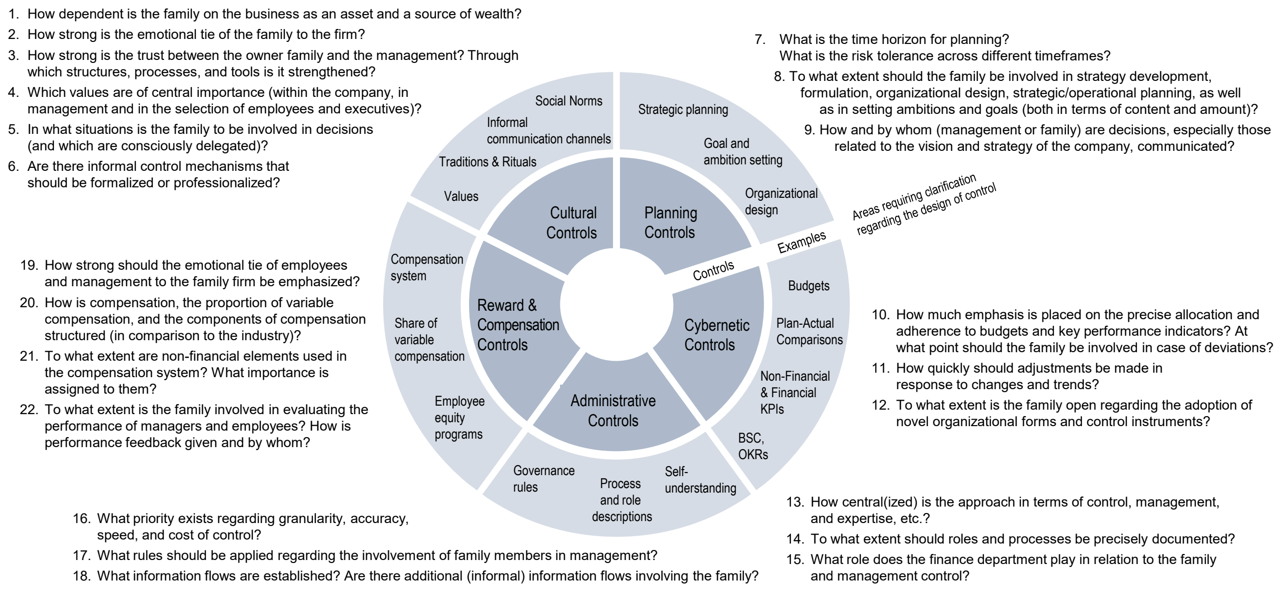

Fig. 2: Management control radar for family firms to compare family preferences and design of the management control system

As the designer of the management control system, controlling plays a central role. Through an open dialog with the owner family, their expectations can be understood and their needs for the management control system can be derived. On this basis, controlling can derive the requirements for specific control elements and the necessary degree of professionalization and thus design the optimal management control system for the owner family. Due to the particular importance of informal controls in family firms, controlling should identify and understand these in particular and, if necessary, manage or promote them in a targeted manner. This requires a comprehensive understanding of family values and needs.

Literature

Anderson, R. C., Reeb, D. M., Founding-family ownership, corporate diversification, and firm leverage, in: The Journal of Law and Economics, 46. Jg. (2003), H. 2, S. 653-684.

Carrasco-Hernandez, A., Sánchez-Marín, G., The determinants of employee compensation in family firms: Empirical evidence, in: Family Business Review, 20. Jg. (2007), H. 3, S. 215-228.

Giovannoni, E., Maraghini, M. P., Riccaboni, A., Transmitting knowledge across generations: The role of management accounting practices, in: Family Business Review, 24. Jg. (2011), H. 2, S. 126-150.

Gomez-Mejia, L. R., Cruz, C., Berrone, P., & De Castro, J., The bind that ties: Socioemotional wealth preservation in family firms, in: The Academy of Management Annals, 5. Jg. (2011), H. 1, S. 653-707.

Hiebl, M. R., & Mayrleitner, B., Professionalization of management accounting in family firms: the impact of family members, in: Review of Managerial Science, 13. Jg. (2019), S. 1037-1068.

König, A., Kammerlander, N., Enders, A., The family innovator's dilemma: How family influence affects the adoption of discontinuous technologies by incumbent firms, in: Academy of Management Review, 38. Jg. (2013), H. 3, S. 418-441.

La Porta, R., Lopez-De-Silanes, F., Shleifer, A., Corporate Ownership Around the World, in: The Journal of Finance, 54. Jg. (1999), H. 2, S. 471-517.

Leenders, M., Waarts, E., Competitiveness and Evolution of Family Businesses: The Role of Family and Business Orientation, in: European Management Journal, 21. Jg. (2003), H. 6, S. 686-697.

Leotta, A., Rizza, C., Ruggeri, D., Management accounting and leadership construction in family firms, in: Qualitative Research in Accounting & Management, 14. Jg. (2017), H. 2, S. 189-207.

Mahoney, J. T., The Adoption of the Multidivisional Form of Organization: A Contingency Model, in: Journal of Management Studies, 29. Jg. (1992), H. 1, S. 49-72.

Malmi, T., Brown, D. A., Management control systems as a package – Opportunities, challenges and research directions, in: Management Accounting Research, 19. Jg. (2008), H. 4, S. 287-300.

Songini, L., Gnan, L., Family involvement and agency cost control mechanisms in family small and medium-sized enterprises, in: Journal of Small Business Management, 53. Jg. (2015), H. 3, S. 748-779.

Speckbacher, G., Wentges, P., The impact of family control on the use of performance measures in strategic target setting and incentive compensation: A research note, in: Management Accounting Research, 23. Jg. (2012), H. 1, S. 34-46.

Stergiou, K., Ashraf, J., Uddin, S., The role of structure and agency in management accounting control change of a family owned firm: A Greek case study, in: Critical Perspectives on Accounting, 24. Jg. (2013), H. 1, S. 62-73.

Zellweger, T. M., Nason, R. S., A stakeholder perspective on family firm performance, in: Family Business Review, 21. Jg. (2008), H. 3, S. 203-216.

Keywords

Family Firms # Family Firm Characteristics # Interdependencies # Management Control Systems

Implications for practice

- The interactions described help controllers and owners of family firms to develop an awareness of the particularities and the development of the management control system.
- Due to the increased relevance of informal controls, controllers should pay particular attention to them, understand them and, if necessary, manage them in a targeted manner.
- Controllers and owners of family firms should engage in an open dialog about their expectations and, for example, the degree of formalization required for the management control system.

Central messages

- The characteristics of family firms have a significant influence on the design of the management control system.
- Due to the special characteristics of family firms, management is characterized less by formal and more by informal, cultural controls.
- The design of specific controls such as planning horizon/intensity or remuneration is influenced by family firm characteristics such as the long-term orientation or risk aversion.