A CORPORATE GOVERNANCE STUDY ON ITALIAN FAMILY FIRMS

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Abstract

In this paper we investigate three corporate governance issues in 30 Italian family firms: (i) the orientation either to the Agency Theory or to the Stewardship Theory; (ii) the board of directors' composition; (iii) the ability to involve nonfamily individuals in the company's management and governance (Openness Index) and the decision-making quality (Extension Index) and we analyze empirical results through a cluster analysis by following the Gubitta and Gianecchini's approach (2002). Our conclusion suggests that (i) small Italian family firms' corporate governance systems seem to be consistent with the guidelines suggested by the Stewardship Theory and (ii) Italian family firms' boards are characterized by a relevant presence of family members.

Keywords: family business, corporate governance, small firms

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Introduction

Family enterprises are firms in which the majority of the capital is held by one, or few, families connected from ties of relative, affinity or solid alliances. They still represent the dominant business model all over the world. In Italy, they account for approximately 83% of the number of medium and small capital enterprises (Corbetta *et al.* , 2002); analogous percentages can be found all around the world. However, this is not a phenomenon that involves only small businesses: in fact, 175 of *Fortune 500* US companies are family-controlled (Anderson and Reeb, 2003). Family businesses are responsible for 50% of U.S. gross domestic product. They generate 60% of the country's employment and 78% of all new job creation (Perman, 2006). These data help understand the importance of family-owned firms in economic activities all over the world. Several scholars still attribute them several self-defeating behaviors such as nepotism and favoritism towards the family members (Kets de Vries, 1996; Gomez-Mejia, Nuñez-Nickel and Gutiérrez, 2001) and suboptimal financing by outside equity, due to family's aversion to external shareholders. On the other hand, family firms are known for a number of strenght points: (i) the involvement of the founder's entrepreneurial talent (Anderson and Reeb, 2003); (ii) the long-term strategic horizon (Stein, 1988; Stein, 1989, Casson, 1999; James, 1999); (iii) the access to cheaper debt (Anderson *et al.* , 2003); (iv) the continuous preferential relationships both with suppliers and financial supporters (Anderson *et al.* , 2003); (v) the reduced agency costs due to the trust among family members (Demsetz and Lehn, 1985; Ang *et al.*, 2000).

In family firms, the entrepreneur is used to concentrate all responsibilities in his hands and the governance structure is not considered a relevant issue. But when the firm grows, the agency costs increase as well. The complexity of business increases with the company's size, and in this case the entrepreneur's talent and instinct might not be enough to handle the new situation (Ward, 1997). Many family firms, with the purpose of reducing the internal lack of knowledge and skills, decide to hire nonfamily managers and to involve them in running the company. In this case, adopting mechanisms of delegation is a critical success factor for the firm: according to the New Theory of Property Rights, the step from strategic planning to action become more complex, since the external managers are now taking part in the coalition and are responsible of one or more organizational units (Gubitta and Gianecchini, 2002). Moreover, as long as the most important decisions are taken by the entrepreneur, or by a restrict number of relatives, these usually come out from informal meetings. By the way, when the firm grows, it is important to create an executive board made up of those family and nonfamily members who hold critical positions in the company. Every family firm owner should understand which type of governance model better fits to his or her firm and how to implement it by taking appropriate decisions about the role, the composition, the size and the tasks of the board of directors and other boards which may have an important role in the firm's governance.

In this paper, we empirically investigate three corporate governance issues in Italian family firms: (i) the orientation either to Agency Theory or to Stewardship Theory; (ii) the board of directors' composition, by introducing a new classification in three board of directors' models (*Familiar Board of Directors, Hybrid Board of Directors, and Evolved Board of Directors*); (iii) the ability to involve nonfamily individuals in the company's management and governance ("Openness") and the decision-making quality ("Extension"), by extending and modifying Gubitta and Gianecchini's approach (Gubitta and Gianecchini, 2002). The paper is organized as follows: Section 2 briefly reviews the literature on corporate governance in family business; Section 3 describes both the research data collection process and methodology; Section 4 illustrates the results of the study; and Section 5 provides a conclusion, by pointing out the key results, briefly discussing the limits of our study, and suggesting new research directions.

Literature Review

Corporate governance is a pivotal subject in business literature, and the debate about the improvement of governance systems is of great interest. Both the theoretical issues regarding corporate governance and the potential benefits achievable through its improvement have been already deeply discussed in literature.

Nevertheless, corporate governance has received an increasing attention during the last two decades (Tricker, 1996; Keasey, 1999). The notion of corporate governance can be dated back to 1932, when Berle and Means argued about the separation of corporate control and ownership that causes executives, rather than owners, to determine the company's strategic development. Nowadays, corporate governance is focusing on the relationships and interactions among some different actors of the firm: shareholders, boards of directors, senior managers and other corporate stakeholders (Cochran and Wartrick, 1988; Tricker, 1996). Concerning the separation between ownership and management, not all studies go towards the same direction. There are two main schools of thought: (i) the *Agency Theory* (Jensen and Meckling, 1976; Fama and Jensen, 1983) and (ii) the *Stewardship Theory* (Donaldson and Davis, 1991; Davis *et al.* , 1997; Muth and Donaldson, 1998). The two theories consider the way the owners can structure the corporate governance systems of their business from different perspectives. In fact, the family can decide to monitor its firm's running in different ways. The family might choose either to act mainly as an owner/inspector, leaving the executive power to professional managers, or to act both as owner and leading manager (Dyer, 1989; Daily and Dollinger, 1992; Gersick *et al.* , 1997).

According to the Agency Theory, the separation between ownership and control requires an "agency relationship", that is an "incomplete" contract between a principal (the family owners) and an agent (the nonfamily managers). Some studies show that dissociation between ownership and managerial decision-making may increase the board's autonomy and the board's effectiveness in monitoring managerial decisions (Fama and Jensen, 1983; Johnson *et al.* , 1993). According to the Agency Theory the main task of the board of directors is to control the managers' actions to avoid their opportunistic behaviours (Muth and Donaldson, 1998). The agent's goals are not generally aligned with the principal's; thus, it is necessary to conform nonfamily manager's behaviour to family owner's objectives through suitable incentive systems and continuous monitoring. However, incentives and monitoring activity cause agency costs as well (Demsetz, 1972). In family companies, separation of ownership from control arises with fragmented ownership and reduced family members' participation in the business (Johannisson and Huse, 2000). The main guidelines this theory suggests in order to build a corporate governance system are: (i) the board should be mainly composed of non-executive directors, in order not to undermine its objectivity; (ii) the positions of CEO and chairman of the board should not be hold by the same person; (iii) the total size of the board should range from 9 to 15 members (Goodstein, Gautam, Boeker, 1994), in order to prevent the strongest directors to influence the boards' decisions (Gubitta and Gianecchini, 2002).

On the other hand, the Stewardship Theory argues that managerial self-interest is not the only relevant issue (Donaldson and Davis, 1991; Davis *et al.*, 1997; Muth and Donaldson, 1998). Doucouliagos (1994) argues that management's motivation is not driven only by self-interest, because of the complexity of human action, not well exlplained by the agency theory. The lackness of the principal-agent theory is a model of man that does not suit the demands of a social existence (Frank, 1994). "In stewardship theory, the model of man is based on a steward whose behavior is ordered such that pro-organizational, collectivistic behaviors have higher utility than individualistic, self-serving behaviors" (Davis *et al.*, 1997).

Applying this framework to family firms, the goals of the family ownership and the nonfamily managers seem to be aligned; thus there are no significant shortcomings in a strong separation between ownership and management. This theory comes to the following conclusions: (i) the involvement of the executive directors increases the effectiveness of the board's activity; (ii) the combined leadership structure is preferable to the separated one; (iii) the size of the board of directors should be small - between 5 and 9 people (Lane, Astrachan, Keyt, McMillan, 2006) - to help the communication among members (Gubitta and Gianecchini, 2002).

Several studies on both theories have been conducted and their results are mixed. There is no reason to argue that one theory is better than the other one, because it depends on many contingent factors. For instance, Davis, *et al.* (1997) explain that there are psychological and cultural factors that affect the results, while Muth and Donaldson (1998) suggest that industry characteristics affect them. Other scholars assert that corporate governance is influenced by institutional factors and that the legal environment defines property rights and sets boundaries within which the companies must operate (Shleifer and Vishny, 1997). Also, the efficiency of capital markets directly affects the corporate governance system in different countries (Klapper and Love, 2004). Lansberg (1999) asserts that most families do not pay enough attention to the governance of their businesses, and that good family firm governance should be the result of good family governance too. In fact, inside family businesses, conflicts can easily arise. Such conflicts may be of several types: justice conflicts, role conflicts, work-family conflicts, identity conflicts, succession conflicts, arguments about power and control, role ambiguities, rivalries between brothers and sisters, conflicts between family members and employees caused by nepotism (Dyer 1994; Cosier and Harvey, 1998; Danes *et. al.* , 1999). Moreover, business decisions sometimes badly affect the family equilibrium (Harvey and Evans, 1994) by creating long-term family feuds (LaChapelle and Barnes, 1998). Thus, the creation of effective corporate governance structures could improve not only the relationships between family ownership and agents, but also the rules and hierarchies established inside the family (Whisler, 1988).

Scholars have tried to establish some guidelines for deciding which features the board of directors' should have. Some researchers affirm that, in order to reduce the lack of competencies, an ideal board should also include active or retired CEOs and other skilled professionals who operate in different areas, such as finance, marketing, operations, technology, law and public policy (Baysinger and Butler, 1985). Regarding the independence of the board, it should be made up of both dependent and independent individuals. A board composed only of insiders and outsiders who depend on insiders might not effectively control other insiders (Lynall *et al.* , 2003). Independent professionals are taken in great consideration because they usually provide firm-specific knowledge and strong commitment towards the company (Sundaramurthy and Lewis, 2003). Concerning the board's size, many scholars affirm that since each member is used to underweight his or her individual responsibility in a bigger group, smaller boards are more adequate for family companies (Ward, 1991; Lane, Astrachan, Keyt, McMillan, 2006). Many of these scholars believe that an effective board of directors should count from 5 up to 9 directors (Forbes, Milliken, 1999; Lane, Astrachan, Keyt, McMillan, 2006). In contrast, other researchers believe that a board ranging from 9 to 15 directors would be more suitable (Goodstein, Gautam, Boeker, 1994). As regards to the frequency of board meetings, family business experience recommends that the board meets formally at least four-six times per year; in addition, an executive committee attended by the main directors, the chairman, and the CEO along with the senior managers should meet once a month (Ward, 1991). However, this threshold should not be overcome, in order to avoid the risk that the board carries over into the role of management. Finally, according to Shen and Cannella (2002) a board member's effectiveness decreases after 14 years. Therefore, in order to keep a director in service for a longer period of time, he or she should still give a substantial support to the company. Ward (1991) recommends maintaining directors in force from two up to three years, even if the terms are reviewed annually, with a mandatory retirement age between 62 and 65 years old.

Methodology

This study has been conducted using the answers of a survey which has been submitted to a sample of 121 family owned Italian firms. Such firms have been sampled from the database provided by the Italian chamber of Commerce (InfoCamere), in accordance with the family business definitions provided by Holland and Oliver (1992) and Daily and Dollinger (1993). Specifically, the family firms have been chosen in respect of the following three basic requirements: (i) the presence of a board of directors; (ii) the presence of, at least, one family member inside the managerial team and the shareholder base; (iii) the coherence with the distributions of age, size, and industry of the companies included in the "Esetra2" survey, which has been conducted in 2003 by the Central Bank Of Italy. We sent an e-letter to each firm, explaining the study and its objectives. Among the family firms that have answered, 30 fulfilled the requirements of the research. In fact, in Italy, most of family businesses are very small and they do not feel the need to establish a formal board of directors, but they usually have a Sole Director. The questionnaire was composed of 48 questions; some needed quantitative answers, while others needed qualitative ones. Interviews were conducted either with a family member operating in the top management or with the top nonfamily manager of the firm. Interviews took place between October 2006 and January 2007, and each interview lasted about one hour and a half.

The questionnaire is divided into three sections. The first section collected data in order to understand which theory, Agency or Stewardship, better fits to the small family owned Italian firms. We considered three main directions of analysis: (i) the board of directors' composition; (ii) the leadership and management; (iii) the size of the board of directors.

The second section examined the relationships between relatives, managers and independent directors. Specifically, we have considered three different kind of board composition: (i) the *familiar board of directors*; (ii) the *hybrid board of directors*; (iii) the *evolved board of directors* (Figure 1).

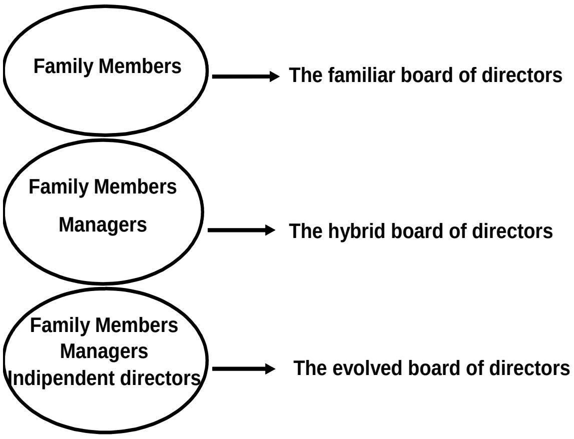

Figure 1. The three models of board of directors

The *familiar board of directors* is totally made up of family members. This type of board is very common in those firms whose decisional power is firmly in the hands of the family, which does not have any intention to share it with other people. The *hybrid board of directors* is composed of both family and nonfamily members. The involvement of the nonfamily managers is an uncritical feature, but it both contributes to widen the portfolio of competences of the family and to support the leader to face the increasing managerial complexity. The *evolved board of directors* is made up of relatives, nonfamily managers and independent directors. The independent directors are non-executive directors who are not directly associated with the family. Their role is to give external opinions inside the board. Their independence is really 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. The compensation of each independent director should be a small part of his or her total income, in order to prevent him from receiving pressures from the family.

The third section concerned the study of the ability of the surveyed firms to open to nonfamily members and measure the quality of their decision-making process. By following the Gubitta and Gianecchini's approach (2002), we computed a modified version of the Openness and the Extension Indexes, in order to better take into consideration the features of the corporate governance system of the family firms in our sample. The Openness Index is a cross-sectional proxy for the capability of the firm's owners to involve managers in both formal and informal boards, and to put them on the head of strategic business functions (Gubitta and Gianecchini, 2002). The Openness Index can be computed using the following:

$$\text{Openness Index} = \frac{\sum \mathrm{M_{nf}}}{\sum \mathrm{M}} \qquad (1)$$

where M_{nf} is the number of all nonfamily individuals who manage business functions or units and all nonfamily members who sit on executive board, board of directors or family council, and M is the number of all individuals who manage business functions or units and all family and nonfamily members who sit on some boards excluded the family council. The Openness Index values can vary among 0 and 1. The '0' value results when there are no nonfamily executives, whereas the '1' value results when there are no family members involved in the board of directors or at the head of business units.

The Extension Index measures the quality of the decision-making process of the firms. This index is based on the idea that there are two main kinds of decisions: (i) the strategic decisions, which are defined as choices that have a high degree of specificity and complexity, that require a great effort, and that might be irreversible, and (ii) the tactical-operational decisions, which can be defined as those that have an impact on the short period rather than on the long run, even if they are very important in the daily management of the company. Unlike Gubitta and Gianecchini (2002) - in order to better take into account the characteristics of the family firms in our sample - we have considered the possibility that the decisions are made from the board of directors, formal and informal executive boards, family council and from individuals as well. We have considered decisions taken by either the chairman of the board or the CEO as the result of a board of directors meeting. In family firms, even in biggest ones, the executive committee is not always formalized, but its role is often replaced by informal meetings to which the business units' heads generally participate. As a result, we have decided to consider the decisions taken inside the informal meetings and the decisions taken by one or more business units heads as they were taken by a formal executive board. On the other hand, the family council should not be a place where strategic and tactical-operational decisions are taken, but a place where relatives can express and discuss their needs, points of view, worries, opinions, values and develop politics and procedures to the service of the family.

The formula of the Extension Index is the following:

$$\text{Extension Index} = \frac{6 - OL - VA - 0{,}75(1^{st}\,type\_error + 2^{nd}\,type\_error + 3^{rd}\,type\_error)}{6} \qquad (2)$$

where OL ("overlaps") is the sum of decisions made by more than one board among family council, board of directors, and executive board; VA ("vacuums") is the sum of decisions never made by any board, 1^{st} *type error* is the sum of tactical-operational decisions made by the board of directors, 2^{nd} *type error* is the sum of strategic decisions made by the executive board and the 3^{rd} *type error* is the sum of both strategic and tactical-operational decisions made by the family council. In order to compute the Extension

Index values, coherently with Gubitta and Giannecchini (2002), we identified the six types of decisions shown in Table 1.

Table 1. Strategic vs Tactical and Operational Decisions

Strategic decisions	Tactical-operational decisions
– Definition of the company's mission and long-term objectives – Financial investment decisions – Definition of the final balance and budget	– Definition of the organizational structure – Evaluation of the competitive advantage, start-up of corrective and development actions – Choice of formal and informal systems for monitoring business performances

Source: Gubitta and Gianecchini (2002)

The Extension Index can range from 0 - when all decisions are taken by more that one governing body or when no one takes any decision - to 1 - when the governance system makes all decisions correctly. After computing both the Openness Index and the Extension Index for every firm of the sample, we analyze the results by considering four groups of companies: low extension-low openness, high extension-low openness, low extension-high openness and high openness-high extension.

Description of the sample

Our sample is made up of 30 Italian family firms. Most of them are small and medium enterprises; only 10% of them have a turnover greater than 50 millions euro, and 30% of them have revenues lower than 10 millions euro. The average turnaround of the sample is 20.8 millions euro. Around 56% percent of the companies are joint-stock companies, whereas the others are limited companies. The average number of employees is 99.87. Twenty percent of the firms employ less than 50 employees, while 16.67% have more than 150 workers. Most firms are still led by their founders (60%), 23.33% by the second generation, 13.33% by the third and only 3.33% by the forth generation. Approximately 43% are B2C (Business to consumer) firms, around 46% are B2B (Business to business) and the remaining are both B2B and B2C. Most companies belong to the metal and mechanical industry (33.33%), whereas the other most common industries are logistics (16.67%) and industrial services (13.33%).

The average number of owners is 5.07, and almost 4 of them are family members. There is a high degree of ownership concentration, since the average share held by the first owner is around 50%. The average number of nonfamily managers that are heads of a function is 2.27. The board of directors is averagely made up of 4.44 members: 3.23 of them are family members, 0.47 are nonfamily manager, 0.47 are independent directors, and 0.27 are external people somehow linked with the family. The board of directors meets, on average, 3.13 times per year. A formal executive board exists in the 40% of the cases. It is averagely composed of 4.92 members, but only 2.08 of them are family managers. Finally, 16.67% of the firms have a formal family council and it is averagely composed of 5 relatives.

Empirical results and discussion

Agency theory vs. Stewardship theory

We asked the firms of the sample if they consider the board as an instrument of defence from potential opportunistic behaviours arising from the external managers. Only 10% of the companies attributes this purpose to the board. Moreover, incentive systems, which are really common in nonfamily firms, are not very diffused (26.7 % of the cases). Both evidence drive us thinking that the managerial opportunism is not so relevant and that the external managers' and the family's goals seem to be aligned. The family firms included in our sample show a large presence of executive directors (71%) and 87% of these executive directors are family members. These data highlight the little separation between ownership and management. In addition, 70% of the firms declares the fusion of the CEO and chairman positions.

With reference to the size of board, in our sample the average number of directors is 4.43. Our findings on Italian family firms seem to suit with the Stewardship Theory's principles.

Board of directors

Firms with a *familiar board of directors model* are the most common (43%), followed by those with an *evolved model* (30%) and those with a *hybrid model* (27%). Firms with a *familiar board of directors model* are also the smallest ones, with an average number of employees around 70 and a turnover around 12.9 millions euro. They are the "oldest" firms of the sample: the weighted average family generation who is running them is close to the second (1.85). The size of this type of board is averagely around 4 family members. Besides, there is a big overlap between the role of the CEO and that of the chairman of the board (more than 80% of the firms). Other formal structures of governance are not very diffused: the executive boards and the family councils are respectively present in the 30.8% and in the 7.7% of the cases. Moreover, both nonfamily shareholders and external managers are not often present in these firms. Indeed, family shareholders account for more than 95% of the total number of shareholders, and on average 80.9%

of business units' heads are family members. Finally, on the basis of our sample, *familiar boards of directors* are the smallest ones, with a mean number of members of 4.08.

Firms with a *hybrid board of directors* are the "youngest" ones (weighted average running generation number equal to 1.25). The role of the external managers is emphasized by their presence in the board: more than 25% of the members is made up of nonfamily managers. By the way, the presence of members who are not employed in the company but who have some kind of relationship with the family is considerable (19.4%). The executive board is quite diffused; 62.5% of the firms has a formal board with a majority of external managers (around 62% of the members). Probably because of the average young age of the companies, the family council is not present at all. Firms with an *evolved board of directors* are the biggest in our sample, with an average turnover of 38 millions euro and a number of employees around 140. The *evolved board of directors* is the biggest in size, with a mean of 4.89 members. The independent directors count for more than 30% of the total number of members, whereas both nonfamily managers and family-linked people are not usually in the board. The family council is present in most of these companies. Comparing firms with a *familiar board of directors model* with those with an *evolved board of directors model*, as the number of actors involved in the board increases, the percentage of nonfamily shareholders increases as well. Firms with an *evolved board of directors model* have an average of 5.56 owners, and only 3.22 of them are family members. On the other hand, firms with *familiar board of directors model* have averagely 5.46 owners, and 5.23 of them are relatives. Moreover, firms with an *evolved board of directors* have not only the highest number of business functions (more than 11), but also the highest percentage of nonfamily business functions heads. Finally, incentive systems are diffused (55.56%), and internal audit systems are very common as well (77.78%).

Table 2. Board of directors: empirical results

	Familiar	Hybrid	Evolved
GENERAL DATA			
Number	13	8	9
Percent to Total	43,33%	26,67%	30,00%
Turnover	€ 12.938.462	€ 13.375.000	€ 38.777.778
Employees	70,5	101,3	141,0
Year of foundation	1959	1947	1971
Family Generation	First 7 (53.84%)	First 6 (75.00%)	First 5 (55.56%)
	Second 2 (15.38%)	Second 2 (25.00%)	Second 3 (33.33%)
	Third 3 (23.08%)	Third 0 (0.00%)	Third 1 (11.11%)
	Fourth 1 (7.69%)	Fourth 0 (0.00%)	Fourth 0 (0.00%)
OWNERSHIP			
Number of Shareholders	5,46	3,88	5,56
·Family ShareHolders	5.23 (95.77%)	2.50 (64.51%)	3.22 (58.00%)
·Nonfamily Shareholders	0.23 (4.23%)	1.38 (35.49%)	2.33 (42.00%)
Highest Stake	49,64%	51,63%	48,17%
MANAGEMENT			
Number of Business Units	8,46	9,13	11,22
·Headed by Family Managers	6.85 (80.90%)	6.88 (75,34%)	8.00 (71.29%)
·Headed by Nonfamily Managers	1.62 (19.10%)	2.25 (24.66%)	3.22 (28.71%)
CORPORATE GOVERNANCE			
Board of Directors' Size (# of members)	4,08	4,50	4,89
·Relatives	4.08 (100.00%)	2.37 (52.78%)	2.78 (56.82%)
·Nonfamily Managers	/	1,25 (27.78%)	0.44 (9,09%)
·Family-Linked Directors	/	0,88 (19.44%)	0.11 (2.27%)
·Independent Directors	/	/	1,56 (31.82%)
Number of Firms with Executive Board	4 (30.77%)	5 (62.50%)	3 (33.33%)
Executive Board's Size (# of members)	4,75	4,20	6,33
·Family Members	2.25 (47.37%)	1.60 (38.10%)	2.67 (42.10%)
·Nonfamily Members	2.50 (52.63%)	2.60 (61.90%)	3.67 (57.89%)
Number of Firms with Family Council	1 (7.69%)	0 (0.00%)	4 (44.44%)
Family Council's Size (# of members)	3,00	/	5,50
Number of Firms with CEO/Chairmain Overlap	11 (84.62%)	5 (62.50%)	5 (55.56%)
Number of Firms that consider the Board of Directors as a protection from managers' opportunistic behaviour	0 (0.00%)	2 (25.00%)	1 (11.11%)
Number of Firms with Incentive Systems	2 (15.38%)	1 (12,50%)	5 (55.56%)
Number of Firms with Internal Auditing Systems	5 (38.46%)	4 (50.00%)	7 (77.78%)

Openness and Decision Making Quality

Figure 4 shows the positioning of the surveyed firms on the basis of the computed values of both the Extension Index and the Openness Index. In order to better interpret the empirical results from our sample, we performed a cluster analysis by the *k-means* algorithm (MacQueen, 1967). As shown in Figure 5, we identified four clusters that logically correspond to those identified by Gubitta and Giannecchini (2002). Cluster may be defined as "connected regions of a multidimensional space containing a high density of points, separated from other such regions by a region containing a relatively low density of points" (Jain and Dubes, 1988). In other words, each cluster represents a subgroup of similar family firms, but that significantly differs from those that belong to other clusters (on the basis of the values of the clustering variables). Thus, we are going to discuss the characteristics of the companies that are in each of the following groups: (i) low Openness Index and low Extension Index; (ii) low Openness Index and high Extension Index; (iii) high Openness Index and low Extension Index; (iv) high Openness Index and high Extension Index.

Table 3. K-means Clustering Output

K-Means Clustering with standardized variables

Final Partition (Number of Clusters = 4)

	Number of observations	Within cluster sum of squares	Average distance from centroid	Maximum distance from centroid
Cluster 1	9	3.372	0.510	1.161
Cluster 2	11	5.337	0.622	1.459
Cluster 3	7	1.991	0.494	0.786
Cluster 4	3	0.574	0.357	0.536

Cluster Centroids

			Logical Meaning	
	Variable 1: Openness Index	Variable 2: Extension Index	Openness	Extension
Cluster 1	0.630	-0.452	HIGH	LOW
Cluster 2	0.556	1.025	HIGH	HIGH
Cluster 3	-1.249	-0.167	LOW	HIGH
Cluster 4	-1.016	-2.011	LOW	LOW

Distances Between Cluster Centroids

	Cluster 1	Cluster 2	Cluster 3	Cluster 4
Cluster 1	0.000	1.479	1.901	2.267
Cluster 2	1.479	0.000	2.164	3.419
Cluster 3	1.901	2.164	0.000	1.859
Cluster 4	2.267	3.419	1.859	0.000

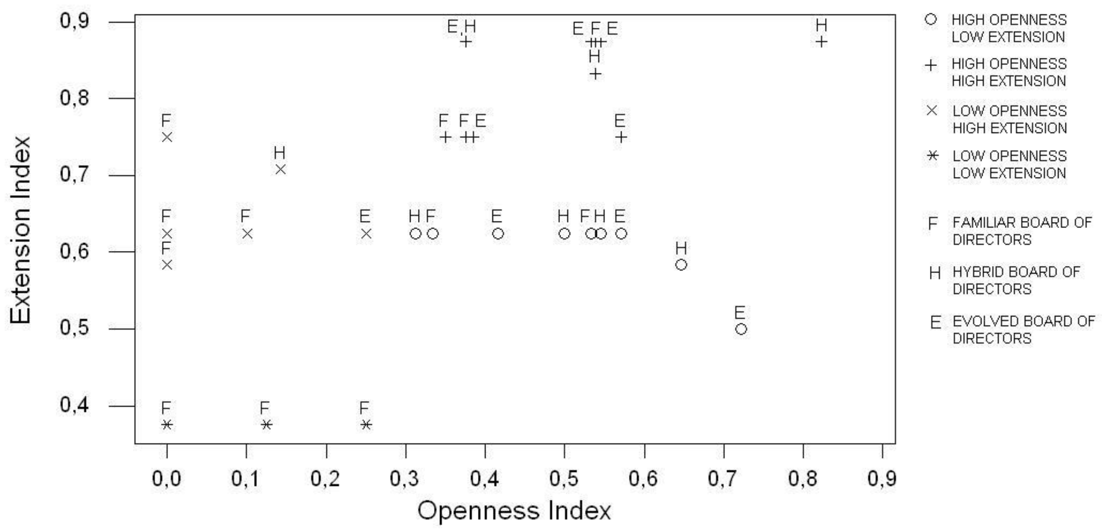

Figure 2. K-Means cluster analysis: the four groups of surveyed companies

Table 4. Openness and Extension Indexes descriptive statistics.

N=30	*Min*	*Max*	*Mean*	*Median*	*Q1*	*Q3*	*Std. Dev.*	*SE Mean*
OPENNESS INDEX	0.0000	0.8235	0.3620	0.3750	0.1384	0.5402	0.2334	0.0426
EXTENSION INDEX	0.3750	0.8750	0.6736	0.6250	0.6250	0.7708	0.1485	0.0271

Firms with low Extension and low Openness are those that have a little developed governance model. All such companies have a *familiar board of director model*; furthermore, with reference to the New Theory of Property Rights, they do not seem to be able to involve external members in the rest of the coalition as well (around 93% of business units heads are family members). They are not widespread in our sample (only 3 companies), and they are the "oldest" ones (weighted average family generation number equal to 2). The ownership is strongly held by the family, and the first owner has, on average, 42.8% of the capital. Moreover, both the high presence of relatives in the board and the low diffusion of formal executive boards reduce the formal hierarchy of the governance system and, consequently, the quality of governance decision-making. The low involvement of external skills in the company and the low decision-making quality make these firms unable to express their full potential.

Firms with a high Extension Index and a low Openness Index are those where the decision-making process is correctly planned, but the nonfamily individuals are little involved in the company's governance and management. The prevailing board model for these companies is the *familiar* one (71.4%); besides, all directors are family members. In addition, the firms in this cluster have the highest mean percentage of family business-functions heads. To sum up, these firms are characterized by the highest presence of family members in the firm's governance and management. Moreover, the number of family members involved in the company management usually grows along with each ownership succession in family businesses. In this cluster, firms that are being run by the third generation have a mean number of family directors of 4 and of family shareholders of 6. On the other hand, firms that are within the cluster but that are being run by the first generation have an average number of family directors of 3.75 and of family shareholders of 4.25. Considering the whole sample, the mean number of family directors is 3 for the first and the second generation, 3.75 for the third and 7 for the fourth; besides, the average number of family shareholders is 2.78 for the first generation, 3.86 for the second, 5.25 for the third and 19 for the company being run by the fourth generation. This phenomenon is called *generational drift*. In order to prevent generational drift from becoming an uncontrollable problem, the family should set procedures to regulate the participation of family members in the ownership. In particular, the family should introduce such formal procedures, develop systems to measure their contributions, establish rewards, and select only the best family members as managers. These firms are the smallest of the sample (on average, they have 70 employees and a turnover around 10 millions euro); their corporate governance systems work pretty well, but their inability to open the ownership, the boards and the management to nonfamily members might not allow them to grow.

In firms with a high Openness Index and a low Extension Index, external managers have an important role in running the firm, but the corporate governance hierarchy is not always respected. The size of these firms is considerable (about 108 employees and 20 millions euro turnover), and they are the "youngest" in our sample, with an average family generation number of 1.33. The prevailing type of board of directors is the *hybrid* one (44.44%), even if both the *familiar* model and the *evolved* model are diffused as well. Nonfamily professionals are significantly involved in managing such companies, with approximately 38% of business units leaded by external managers. Concerning the ownership, the firms in this cluster have the highest mean percentage of nonfamily shareholders (27.3%) in our sample, but – on average – the main shareholder holds a very high stake (67.2%). The big dimensions of these companies, often reached in a short time, suggest that the considerable involvement of external managers supported their growth pretty well. On the contrary, the corporate governance systems of these firms are usually affected by some confusion of roles (both 1st type and 2nd type errors are very common), which is responsible for their low decision-making quality.

Finally, firms with a high degree of both Extension and Openness should be taken as best practices. Concerning the ownership structure, they have the highest mean number of shareholders (6.27), and the highest average percentage of nonfamily ones (around 35%). External managers are significantly involved in the company's management: around 25% of business functions heads are nonfamily members. Moreover, their board of directors is the largest in our sample (around 5 directors), and the prevailing model is the *evolved* one (45.5%); the board of directors meets quite frequently, averagely 3.38 times per year. The formal executive board is widespread (it is present in the 72.7% of the cases) and most of its members are nonfamily individuals (64.4%). The companies in this cluster are the largest of the sample, with an average turnover around 29 millions euro and a mean number of employees of 117.1. Both incentive and internal auditing systems are quite diffused in these companies, and – although the overlap between CEO and chairman roles is considerable (63.6%) – all the firms that consider the board as a protection from managers' opportunistic behaviour fall in this cluster (however, they represent only 27.3% of the companies in the cluster).

Conclusion

In this paper, we have empirically investigated small Italian family businesses' corporate governance from three different perspectives. Although the research is limited by the small number of companies, our study suggests the following findings:

i) *Agency theory vs. Stewardship theory*. Small Italian family firms' corporate governance systems seem to be consistent with the guidelines suggested by the Stewardship Theory.
ii) *Board of directors.* The *familiar board of directors model* is the most diffused in small Italian family firms, although both the *hybrid* and the *evolved* models are quite common as well. Moreover:

- firms with a *familiar* board of directors are relatively smaller and older than other ones, have both ownership and management structures with a dominant presence of family members, and formal corporate governance structures (executive board, family council) are not diffused;
- firms with an *evolved* board of directors are relatively bigger than other ones, nonfamily members have a high incidence in their ownership and management structures, independent directors rather than both

nonfamily managers and family-linked directors represent a significant part of the board of directors, formal executive boards and family councils are quite diffused, and both incentive and internal auditing systems are widespread.

- firms with a *hybrid* board of directors are, on average, bigger than those with a *familiar* board of directors, but smaller than those with an *evolved* one; they are relatively young, there are some nonfamily members involved in both their management and ownership structures, nonfamily managers and family-linked directors are relevant in the board of directors' composition, and most companies have a formal executive board.

Table 5. Openness and Decision Making Quality: empirical results

	Low Openness - Low Extension	Low Openness - High Extension	High Openness - Low Extension	High Openness - High Extension
GENERAL DATA				
Number	3	7	9	11
Percent to Total	10.00%	23.33%	30.00%	36.67%
Turnover	€ 16,333,333	€ 10,385,714	€ 20,277,778	€ 29,090,909
Employees	82.7	70.1	107.7	117.1
Family Generation	First 1 (33.33%)	First 4 (57.14%)	First 6 (66.67%)	First 7 (63.64%)
	Second 1 (33.33%)	Second 1 (14.28%)	Second 3 (33.33%)	Second 2 (18.18%)
	Third 1 (33.33%)	Third 2 (28.57%)	Third 0 (0.00%)	Third 1 (9.09%)
	Fourth 0 (0.00%)	Fourth 0 (0.00%)	Fourth 0 (0.00%)	Fourth 1 (9.09%)
OWNERSHIP				
Number of Shareholders	5.33	4.86	3.67	6.27
·Family ShareHolders	4.67 (87.50%)	4.86 (100.00%)	2.67 (72.73%)	4.09 (65.22%)
·Nonfamily Shareholders	0.67 (12.50%)	0 (0.00%)	1.00 (27.27%)	2.18 (34.78%)
Highest Stake	42.83%	40.70%	67.17%	43.09%
MANAGEMENT				
Number of Business Units	9.67	7.57	10.11	10.09
·Headed by Family Managers	9.00 (93.10%)	7.29 (96.23%)	6.22 (61.54%)	7.45 (73.87%)
·Headed by Nonfamily Managers	0.67(6.90%)	0.29 (3.77%)	3.89 (38.46%)	2.64 (26.13%)
CORPORATE GOVERNANCE				
Board of Directors' Size (# of members)	4.33	4.00	4.44	4.73
Board of Directors' Type	Familiar 3 (100.00%)	5 (71.43%)	2 (22.22%)	3 (27.27%)
	Hybrid 0 (0.00%)	1 (14.28%)	4 (44.44%)	3 (27.27%)
	Evolved 0 (0.00%)	1 (14.28%)	3 (33.33%)	5 (45.45%)
Board of Directors' Meetings per Year	1.67	2.79	3.28	3.64
Number of Firms with Executive Board	1 (33.33%)	1 (14.28%)	2 (22.22%)	8 (72.73%)
Executive Board's Size (# of members)	2.00	4.00	5.50	5.25
·Family Members	1.00 (50.00%)	4.00 (100.00%)	2.50 (45.45%)	1.87 (35.62)
·Nonfamily Members	1.00 (50.00%)	0.00 (0.00%)	3.00 (55.55%)	3.38 (64.38)
Number of Firms with Family Council	1 (33.33%)	1 (14.28%)	1 (11.11%)	2 (18.18%)
Family Council's Size (# of members)	3.00	3.00	11.00	4.00
Number of Firms with CEO/Chairmain Overlap	3 (100.00%)	6 (85.71%)	5 (55.56%)	7 (63.64%)
Number of Firms that consider the Board of Directors as a protection from managers' opportunistic behaviour	0 (0.00%)	0 (0.00%)	0 (0.00%)	3 (27.27%)
Number of Firms with Incentive Systems	0 (0.00%)	1 (14.28%)	3 (33.33%)	4 (36.36%)
Number of Firms with Internal Auditing Systems	2 (66.66%)	1 (14.28%)	7 (77.78%)	6 (54.54%)

iii) *Openness and Decision Making Quality*. In accordance with Gubitta and Gianecchini (2002) findings, Italian family firms can be divided into four categories on the basis of the Openness Index and the Extension Index values:

- Low Openness and Low Extension. These companies are incapable to involve nonfamily members in their management, ownership and corporate governance structures; furthermore, they fail to establish and effective hierarchy in the corporate governance systems: as a result, they have a low quality decision-making. These firms are relatively old, and they are not very common.
- Low Openness and High Extension. In these firms, decision-making process is correctly planned, but the nonfamily individuals are little involved in the company's governance and management. Like companies with both low Openness and low Extension, their owners, managers and directors are almost all family members. However, these companies are more diffused and, above all, smaller than them: in fact, they have a lower turnover, a lower number of employees, and a less complex organizational structure. The limited size of these firms probably helps them effectively arrange their corporate governance decision-making processes.
- High Openness and Low Extension. In these companies, external managers have an important role in running the firm, but the corporate governance hierarchy is not always respected. They are relatively younger and bigger than firms with a low Openness, the prevailing board of directors model is the *hybrid* one, and formal corporate governance structures (executive board, family council) are not diffused.
- High Openness and High Extension. These companies succeed in both involving external professionals in the firm's running and achieving a high decision-making quality. They are relatively big and, although family members still play a primary role in the company, external individuals are significantly involved in ownership, management, and corporate governance. They usually have a formal executive board, and the more common board of directors' model is the *evolved* one.

A larger sample of family firms would allow reinforcing the validity of our results. By the way, we underline that most small Italian family firms have a sole director rather than a board of directors, and our sample has been selected among only those firms with a board of directors.

A logical extension of this study includes the analysis of the relationship between family firms' performances and their corporate governance choices, in terms of (i) board of directors' model, and (ii) Openness and Extension. Moreover, it would be interesting to analyze what are the main contingent variables that are relevant to explain why a family firm chooses a certain board of directors composition, decides to involve nonfamily professionals in the company, and introduces mechanisms that allow the company to achieve a high level of Extension.

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