Governance Systems in Family SMEs: The Substitution Effects between Family Councils and Corporate Governance Mechanisms

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Corporate governance systems are hierarchical and based on the assumptions of agency theory. In family firm context, the relational perspective also becomes relevant. These perspectives lead to three basic governance roles: the ownership role, monitoring role and leading role. This study examines the governance roles of family council in small and medium family businesses (SMEs). It evaluates whether in addition to family governance the family councils also perform corporate governance roles.

The study is based on a sample of 243 Italian small and medium family firms. This summary presents the key findings of the study and its implications for family firms.

Agency based Contractual Perspective of Governance

Agency theory looks at firms from a contractual viewpoint. The governance goal from agency perspective is to align the interests of owners and managers. This goal is achieved by a clearly defined principal-agent hierarchy of governance mechanisms. Shareholder's meeting, Board of directors and the CEO are the key governance mechanisms that take ownership, monitoring and leading roles, respectively.

There are mixed opinions on agency-based control roles of corporate governance mechanisms in family business context. Some researchers suggest that in family firms agency problems are less because owner-manager interests are highly aligned. Some others scholars argue that family firms may have family-specific agency problems like asymmetric altruism or conflict of interest between family majority and family minority owners.

Relational Perspective of Governance

Relational perspective focuses on common interests that motivate individuals and help achieve those goals with governance systems based on cooperative, non-contractual logic.

Stewardship theory based on relational perspective represents agents as cooperative and pro-organisational. Commitments to values, collectivist culture, considering power as a means to serve, and trust-based management philosophy characterize stewardship.

Family governance mechanisms develop and promote these values and behaviours. This is achieved through two tasks that family councils perform:

1. Designing and managing relationship between the family and business, and

2. Planning the inter-generational transition.

Family councils allow family members to express their views, discuss opinions, share values and visions and develop plans. Hence, family councils act as an important governance mechanism in family business.

Substitution Effects between Family Councils and Corporate Governance Mechanism

The authors posit that in family business context (especially for family SMEs), the family councils also play an important role as corporate governance mechanisms. More specifically, they suggest that in family SME context when an active family council is present then:

1. The corporate governance role of ownership played by the Shareholder's meeting diminishes.
2. The monitoring role played by the Board of Directors diminishes, and
3. The leading role played by the CEO diminishes.

The governance role of the above bodies diminishes because the family council substitutes them in part. The survey confirmed these postulates, signifying the importance of family council as an effective governance mechanism in family business context.

Practical Implications

The study has important implication for family business. Often, family governance partly substitutes corporate governance mechanisms, especially shareholders meeting and Board of Directors. This substitution effect is likely to take place more frequently when most family members are both owners and directors.

However, it is paramount for family firms to establish legal corporate governance mechanisms. They need not wait for regulatory push to establish these mechanisms but be proactive in doing so. It is always advisable to make an early beginning in establishing governance systems. The corporate governance body must ratify the decisions made by a family governance body, even when there is high overlap between the two governance systems. This will improve and strengthen the overall governance structure of the family business.

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