Short Notes about Financial Reporting in Italian Family Businesses

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Abstract

The main purpose of the paper is to analyse some features regarding economic and financial communication in Italian family companies. This is a theoretical essay focuses on to point out the new role played by balance sheet as a public document which carries all information needed by players operating both inside and outside the company. Paper shows the long and troubled process of transforming balance sheet from internal document to an official document useful to stakeholder to measure and evaluate family business performance and to implement accountable and responsible behaviour. The most important aspects being considered are: 1) the relationship linking balance sheet and stakeholders; 2) the relationship between company-family and patrimony-marriage; 3) the consequences caused to the balance sheet by measurement regulations.

Keywords: *family business, balance sheet, accountability, financial reporting, firm behaviour, stakeholders*

JEL classification: L20, M41

1. Financial Reporting: historical process of balance sheet role

The subject of financial reporting with relation to Italian family businesses, particularly the small ones (Carsberg B. V. *et al*. 1985), has not received yet the attention it deserves[1]. That is true for scientific literature, company policies and professional codes of conduct. In scientific studies, as it has been authoritatively pointed out (Capaldo P. 1998; Terzani S. 2002; Viganò E. 2007), *income and balnce sheet were considered the same until the mid-60s* and therefore never studied separately, as in a relationship between medium and goal.

[1] Such oversight is also to be found in some studies focusing on consumption entities. Colombo G., in Mella P., Velo D. (edited by), (2007).

The study of the balance sheet, considered as a mere instrument towards the measurement of income, was likened to the study of the income itself (Copland T. *et al*., 1990), which was in turn analysed considering its origin and nature, its different configurations and variety of determination criteria (Capaldo P. 1998). That marks the first historical period[2], during which the balance sheet had a predominantly internal function: the academic debate was mainly about the object of the balance sheet itself, assessment criteria and the relationship between income and working capital. Moreover, a relationship between accounting practice and academic speculation had just been established[3]. The public role, and to some extent even the legal role of the balance sheet, were *de facto* ignored. At the time the distinction between the internal and the official balance was clearly drawn, the former being the only faithful document and the latter a formality bearing little practical relevance (Capaldo P. 1998): a repetitive and boring administrative assignment[4].

On the one hand there was the balance sheet for the taxman, banks and funders, on the other the document for the owner and his/her family. As pointedly remarked, *Italian authors have mainly studied the internal balance sheet because the typical company was closed to its environment: the official document became a legal (actually just fiscal) obligation. (...) a typical Italian company did not have shareholders; was not part of any financial community; did not have a stock market (only the bank) requiring a balance sheet. (...) On the other hand, the internal document did not have to comply with requirements regarding form, information conveyed, faithfulness*[5]. It is therefore quite clear why studies on the subject implicitly focused on the internal balance (that is capital and income) and *ignored* - at times purposely - a great deal of the legal requirements and implications of the official document. The idea behind that approach was that legal paraphernalia

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[2] According to some authors it is possible to sort four different periods with regard to accounting information:
- (1900 – 1950): information mainly aimed at people operating within the company,
- (1950 – 1970): information mainly aimed at people operating outside the company – 'public balance',
- (1970 – 1995): corporate reporting,
- (1995 – 2005): economic and financial reporting.

Adamo S. (2005).

[3] During the Thirties the balance sheet was not affected yet by the speculations of the Italian Masters of Accounting and Business Administration, but it was still laid out according to early century's principles and practices. Amaduzzi A. (2004)

[4] The formulation of the balance sheet, in any company, follows a twofold process: on the one hand, data are gathered for the benefit of directors and their 'inner circle', that is of people who have actually run the company and want to know about the results of their management strategies and policies; on the other hand, there is the communication for the benefit of 'outsiders', having more 'official' aims. Amodeo D. (1964).

[5] When studying the 'public' balance Italian business academics take for granted that it has to be minutely regulated by the Civil Law and commented by lawyers. They only try to give economic interpretations to lawyers' (both academics' and judiciary's) hair-splitting disputes. Viganò E. (2007).

could not get all the complexities of corporate life (Capaldo P. 1998), which implied a sort of peculiar and eccentric competition between disciplines over the same object of study. It took some time to the operators involved to acknowledge the fact that the balance sheet, especially for companies with broad based shareholding, could not remain for ever a matter for directors and major shareholders only. The balance sheet was more and more perceived as an instrument apt to give all necessary information to the parties involved (Capaldo P. 1998), either inside or outside the company. Some authors (Viganò E. 1973) acutely stress how the balance sheet went from being:

- a simple informative tool for the compiler,
- to behavioural test,
- and eventually to paramount communication tool for the benefit of anyone outside the company.

That is because financial communication is not so much an end *per se* as something which makes sense only when seen in context (which means taking into account both exogenous and endogenous factors). The number and diversity of positions involved and the impossibility of sorting and controlling all the players at any given time *affirmed the global and public role of the balance sheet*, with obvious economic, legal and social implications (Capaldo P. 1998). It was not by accident that the first social balance was laid out during the 1970s by Merloni, a classic example of Italian family business. That landmark event broadened the horizon of Italian companies (Bartocci M. 1979).

Due to the simultaneous, albeit not predetermined, action taken around mid-70s by different players (namely the judiciary, academics, national and European legislature) *the balance sheet was completely transformed. Change was about structure, control (with the introduction of the auditing process) and above all about the attention that managers and directors* were giving to the document (Capaldo P. 1998). Auditing was a huge innovation, which greatly affected company procedures and the way the balance sheet had been seen until then. The attention given to the document increased further after the acceptance of European legislation. The first part of a long and troubled process of accounting harmonization ended in Italy at the beginning of the 1990s. The notion of the balance sheet as a complex and thorough information tool had eventually been affirmed.

2. Small Family Business in the Italian context

We need to specify what kind of Italian company we are referring to here. It is that particular family business (Corbetta G. 1995) we could call strictly proprietary, closed and undemocratic. In other words, that economic entity which:

a) adopts family governance as the only managerial model and whose administration is based on a web of interpersonal relationships and on the informal exchange of information among its members,

b) shows a widespread mingling between family and company of both capital and income, bringing confusion and uncertainty to company and family management altogether,

c) often owes its commercial success to the founder's creativity and animal spirits,

d) is either small or very small and whose ownership is in the hands of one/few family/ies,

e) develops a usually closed proprietary structure.

Therefore we are not going to consider large Italian family businesses which, for better or worse[6] form the backbone of Italian economy and have structural and managerial features that strongly affect their financial communication (Giusepponi K. 2003; Carroll A. B. 1987).

At the beginning of the 21st century the family business behaviour has entered a new era (Palma A. 2003), marked by a new interest in communicating through the balance sheet and in the subject of accounting harmonization. While the balance sheet accounts for ever larger areas of corporate activity, the old distinction between internal and official balance disappears, both in theoretical works and in corporate practice: the only *true* balance is now the official one, which carries all the information needed by players operating both inside and outside the company.

Family business started to use balance sheets do carry important information and we can now safely assume that the overall quality of corporate communication is indeed good (Capaldo P. 1998).

The attention towards the balance sheet has also increased thanks to a new economic and social climate, and to new professional figures such as the investor relator *who provides information and comments about company performance in different ways and with a different degree of insight and detail, depending on the size and complexity of the company itself* (Terzani S. 2002).

All that applies to a lesser degree to family businesses, which are left behind not only from a *dimensional* point of view but also and above all when we take into account their *relational* capability (Vermiglio F. 2007).

According to some important business economics scholars, dimension is defined looking at several parameters and criteria which are in some cases alternative, in others complementary (Epstein E. 1974). The number of employees and the amount of invested capital are the two most commonly used parameters assessing company size, even though other environment-specific factors might be taken into account in most cases. It has been acutely observed that the notion of small, medium and large company should be defined according to the role companies play in a society's development process.

Using this criterion, *large companies are those which play a decisive role on a national and international scale. Small companies are conversely those which*

[6] (...) Our country's industrial model remains indeed anomalous, closed between family- and government-owned business, both being disastrous escapes from the free market. Rossi G. (2003).

are not able to affect economic and living conditions on a large scale. Finally, companies which can somehow affect economic development, albeit not in a decisive way, can be considered as medium-sized (Bertini U. 1969). So family businesses that want to become relevant have to improve their relationship with external environment to become leading player in the market. Looking at balance sheet as useful tool of financial reporting and communication, small family business can change their behaviour becoming more accountable and responsible towards their stakeholders improving leadership (Freeman R. E., Mcvea J. 2002).

Family business features we are going to briefly analyse are:

1. the relationship existing between balance sheet aims/goals and information recipients,
2. the relationship existing between company-family and estate-matrimony,
3. consequences in accounting terms of limitations imposed on the measurement process and procedures.

3. Balance sheet to improve Family Business leadership

About the relationship existing between balance sheet aims and information recipients, it has been recently pointed out (Paoloni M., Cesaroni F.M., Demartini P. 2003) that Italian small family businesses show on average *low transparency and a limited development of their informational system, which is often limited to the processing of postings necessary to balance sheet completion*. All works have stressed the marginal role of the balance sheet, seen as *nothing more than a mere administrative task companies are obliged to perform by law*. The notion of the balance sheet as a vehicle for information is hardly known. *Only a handful of companies, usually the most advanced ones or those which operate within certain markets, give the balance sheet the importance it deserves, with particular regard to the relationship existing with some influential players operating outside the company itself* (Paoloni M., Cesaroni F.M., Demartini P. 2003).

The use of tools such as period analysis, periodic reports, budgets over one or more years, financial and economic programmes, strategic and executive plans etc. is rare. The fiscal variable is considered producing negative effects while the balance sheet is usually given the following functions, from the most to the least important (Paoloni M., Cesaroni F.M., Demartini P. 2003):

1. *fiscal function,*
2. *control function,*
3. *informative function for/towards banks,*
4. *informative function for/towards customers and suppliers,*
5. *informative function for/towards non-operative partners.*

Positive effects are produced by the action of funders and investors, *who push small Italian companies to improve the quality of their financial communication. Companies are forced to acquire new skills, to set up new informational procedures* and to broaden their communication system, all that ultimately leading to cultural change (Paoloni M., Cesaroni F.M., Demartini P. 2003; Mcmahon R. *et al.* 1993). Only an intense stimulus towards a suitable accountability system can actually improve the company's network of relations, therefore boosting its reputation and credibility. The term *accountability*, widely used in recent years, should define to what degree individuals or institutions willing to know about the life of any economic entity – privately or publicly owned, large or small, family-owned or not – are able to evaluate its administration and management. The conditions in which assessments are produced depend on the quality of the company's accountability system. Factors which contribute to determine the accountability of a company are:

1. a clear and thorough programming process,
2. a clear definition of internal and external duties,
3. a suitable accounting system,
4. an effective internal system for control and evaluation,
5. a periodic informative activity about company management,
6. the use of benchmarking procedures,
7. the use of up-to-date technology in the communication process.

The higher the level of those factors, the more accurate the evaluation process usually is. The term *accountability* is therefore also about how and to what degree a company is able to allow third parties to evaluate actions taken. That inevitably pushes company managers and their closest counterparts to take full responsibility for their decisions. It is quite clear that a lot is yet to be expected from small Italian family businesses, with particular regard to the implementation of financial communication systems, which while being less sophisticated, wide-ranging and expensive than those chosen for use in bigger companies, should still be able to provide all the information needed by third parties (Devecchi C. 2007; Hopwood A. G., Miller P. 1994).

Writing about the relationship existing between family-business and patrimony-matrimony, it is quite clear how the well-known 'shyness' in providing information is the effect of a defensive attitude aimed at protecting the company's sensitive data regarding capital and income. The almost perfect overlapping of the two entities makes most Italian family businesses almost impregnable when it comes to gathering information, particularly if that is meant to be shared with third parties operating outside the company. Family life and company life tend to coincide: company affairs are family affairs and vice versa.

Family matters tend to affect business matters and vice versa, melting into each other, up to the point of losing their original features. All that makes the decisional process to a certain extent very effective (Fitoussi J.P. 2004)[7] but also has its limits: everything becomes intimate, private, to be kept in the family, to be hidden from strangers and sometimes even from neighbours; communication regarding the company must be protected, also to avoid that judgements about the company might become judgements about the family. That kind of (unorthodox) communi-

[7] This contribution might elicit a debate about the fascinating analogy between the market-government relationship on the one hand, and the family-business relationship on the other

cation and external relations management can lead to superficial and uneffective behaviour (Zocchi W. 2004).

4. Some conclusions and considerations

The quantification of consumption and expenses with relation to family members is another major issue which is widespread, for example, in small family hotel businesses (Avi M.S. 1995): family needs are usually entirely charged to the business account even when they do not have anything to do with the running of the hotel, also in order to increase its level of tax-deductible expenses. It must be said that while this kind of behaviour is not usually carried out only for tax-saving purposes, it would also be difficult and inappropriate trying to quantify family expenses in certain contexts. The mere attempt at measuring personal expenses with regard to family members would cause an immediate deterioration in family (and therefore business) relations. We are going to briefly list here other company and family policies (Pugliese A. 2006; Tiscini R. 2001; Pini M. 1995) which pathologically affect the drawing up of the balance sheet:

- the purchase and the improper use of business assets by family members,
- the concession of loans or hidden funds to family members,
- the fake capitalization of the company through the provision of resources only apparently referable to family members,
- large compensation bonuses given to family managers not otherwise remunerated,
- the purchase and the improper use of family assets by the company,
- the uncertain number of suspended financial transactions waiting to be accounted for,
- rejecting the notion of profit as something indicating the company's capacity of repaying the invested capital, hence the decision not to pay dividends.

The difficulty in acknowledging the importance of the balance sheet to the measurement and analysis of the economic value of any family business do the rest. A much debated consequence of this attitude is the undercapitalization of the Italian family business, which in turn causes an increase in corporate risk.

All this, however, could change soon due to some recent developments affecting for the better the area of financial communication (Canessa N. 2006). Small Italian family businesses might benefit from a series of events, most of which already considered by academic literature (Pugliese A. 2006):

1. the development of international competition,
2. the development of some sort of co-operation between companies,
3. the introduction of international accounting standards,
4. the Basel agreement with relation to bank loans,
5. recent developments in fiscal policies.

We shall not write here about the first two points. About the third one, we would like to stress here that the introduction of accounting regulations primarily geared towards the financial investor has caused quite a few problems to small Italian family businesses. It could be actually said that either the *Great Wall of China* which Prof Dezzani (2006) speculated upon, or our *Hadrian's Wall*[8] seem even more impregnable when referred to small Italian family businesses. IASB theoretical framework could in fact fit all companies, regardless of their size, only if the notion of the balance sheet is somehow broadened and reconsidered or, conversely, *a new way is found to acknowledge the peculiarities of different types of companies* (Di Pietra R. 2005). However a simplification process is under way, aiming at reducing unnecessary requirements which only bring marginal benefits in terms of information provided (Di Pietra R. 2006; Bianchi M.T. 2008; Poselli M. 2006).

The Basel agreement has introduced new elements towards the regulation of the relationship between banks and companies, for more efficient financial markets. A more professional and detached relationship between the two players should result in more truthful accounting statements produced by Italian family businesses. Finally, it is worth stressing that the Italian taxman has been loosening its grip on Italian accounting systems and regulations, therefore leaving no room or excuse for improper accounting behaviour.

These are some of the reasons why both financial and social information are assuming a new meaning to small Italian family businesses. Their balance sheet could therefore:

- ✓ become a true priority for the socially responsible company, rather than a mere documentation tool,
- ✓ shift from bureaucratic requirement to act of *public service* towards a more transparent and efficient financial market,
- ✓ move from being simply an instrument for the evaluation of business governance to being an opportunity towards better business planning.

Finally, we would like to mention here an interesting question brought up by a dear colleague a while ago during another conference (Capodaglio G. 2006): *do small* (we might as well say familiar) *businesses produce small balance sheets?*

We do not think so, but the risk is present if the players involved do not acknowledge some complexities or are not able to turn some threats into opportunities.

[8] It is interesting observing how, according to Prof Flavio Dezzani, there is a Great Wall of China dividing Italian and international accounting standards. Still metaphorically, and considering both the players involved and their nationalities, we might also think at the famous Hadrian's Wall, the fortification built around 120 AD under Emperor Hadrian's rule in order to separate Romans from barbarians (the Wall, 117 km long, was abandoned in 383 AD).

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