Management accounting in the family business: tipping the balance for survival

Structured Abstract

Purpose: This article aims to present the family business-specific benefits of taking a proactive approach to using management accounting practices and information.

Design/methodology/approach: The (scarce) literature on management accounting in family businesses is used to discuss the obstacles and benefits of management accounting in family businesses. The benefits are presented using the Three-Circle Model, which displays the family business system consisting of the three subsystems ownership, business and family.

Findings: For family businesses, the main benefits of (increasingly) using management accounting should lie in codifying tacit knowledge, preparing for family and non-family succession, facilitating more fact-based decision-making and alleviating the production of proper information of non-family investors and creditors.

Practical implications: Family business owners, as well as non-family managers in family businesses, might find helpful food for thought regarding how to establish or develop further the management accounting system in a family business.

Originality/value: This article is among the first to discuss the benefits of management accounting for family businesses.

Keywords: Family Business, Family Firm, Management Accounting, Succession, Knowledge Transfer, Codify Knowledge

Type: Research paper

Introduction

All around the industrialised world, family businesses form the majority of firms: in the USA, it is estimated that up to 96% of all firms are family businesses; in Europe, the numbers range from 60% to 93%; and in Australia, 75% of all firms are considered family businesses (IFERA, 2003). However, when taking a closer look, it becomes evident that family businesses prevail amongst small and medium-sized firms but not amongst large firms. For instance, in Germany, amongst firms with less than 50 million Euros in annual sales, more than 60% of these firms can be regarded as being family-controlled. However, amongst firms with annual sales of more than 500 million Euros, the family business share decreases to less than 30% (Klein, 2000). These statistics already indicate that with growing size, family businesses collapse, split up, are taken over or otherwise develop into non-family corporations. This notion receives further support when looking at family business survival rates: only 12% of all family businesses reach the third generation, and as few as 3% reach the fourth or further generations (Allio, 2004).

One reason for this high mortality rate of family businesses has been found in insufficient strategic and succession planning in family businesses (Allio, 2004). However, another – so far not prominently discussed – reason might also lie in inadequate operational planning. As recent results have shown, smaller family businesses use significantly less planning instruments than non-family businesses (Hiebl *et al.,* 2013), which might also help to explain the family business mortality rate. Moreover, family businesses were generally found to use fewer management accounting instruments and to employ fewer specialised management accounting departments (Feldbauer-Durstmüller *et al.,* 2012). Thus, family business managers might also lack crucial information about current risks or underperformance in certain areas of the business, as well as about the well-performing parts of the business. Yet another reason for the high failure rate of family businesses might be found in the difficult dissemination of tacit and implicit knowledge when family businesses are handed over to the next generation. This point could be crucial, as family businesses tend to rely to a high degree of implicit knowledge amongst the family owners currently managing the firm (Sirmon and Hitt, 2003). A potential cure for all three of these potential reasons of family business failure was recently found in the proactive usage of management accounting in

family businesses (Giovannoni *et al.,* 2011). Using a single case study approach, Giovannoni *et al.* (2011) showed that the introduction of management accounting practices, such as budgeting and the balanced scorecard, forced the founding family member to codify his so-far implicit knowledge, to formalise the strategic vision for the family firm and therefore to facilitate the business's succession to family and non-family managers. As a result, the present article aims to shed more light on how family business owners can choose a road of proactively using management accounting information in family businesses. To be clear at the very outset, the term "management accounting" is understood as all of the practices and institutions designated for planning, budgeting and performance appraisal (Giovannoni *et al.,* 2011).

Management accounting? Maybe later, when we really need it! – Reasons, why family businesses choose not to use management accounting information

Family businesses often rely on specific resources to create a competitive advantage. One such resource is a lower level of formalisation and a higher degree of flexibility (Sirmon and Hitt, 2003). In this way, family businesses are highly focused on delivering competitive products or services, and they avoid cost-intensive overheads. As long as the family business is small, and the family manager is able to overlook all of the important operations and projects, lesser formalisation can be regarded as a true competitive advantage. However, if the family business successfully develops and grows, even the most engaged and able family manager might not be able to bear all of the details in his or her mind anymore (Giovannoni *et al.,* 2011). Even worse, he or she might simply lack the time to coordinate all of the practices and operations in the grown firm, which might cause non-operation periods, idle time costs or scrap and rejects. At this point, the family manager might consider employing non-family managers, delegate more tasks and/or introduce more formalised practices. For instance, simple actions, such as writing down operational plans or budgets, is a sort of formalisation, but it enables the employees of the family business to know what to do without asking the family manager at every step.

However, will the family manager really introduce such formalised practices? The family manager might still think that as long as he or she knows where to go, this knowledge is sufficient. Another thought might be that employing specialists for the planning and coordinating of tasks, such as management accountants, might only be a waste of money, as these employees do not earn a single dollar/pound/euro but only increase the firm's labour costs. So why not continue as before?

This practice of "muddling through" might still work for a period of time, but sooner or later, the family business is likely to get to the point at which firm size and increased complexity simply make more formalisation inevitable. This result has also been confirmed by research, which has shown that when comparing smaller firms, family businesses show significantly lower levels of management accounting institutionalisation than non-family businesses. However, when comparing larger family firms to larger non-family firms (having more than 250 employees), there were no significant differences in the level of usage of management accounting practices observable anymore (Hiebl *et al.,* 2013). This finding indicates that crossing the threshold of a certain firm size finally leads to increased usage of management accounting, including in family businesses.

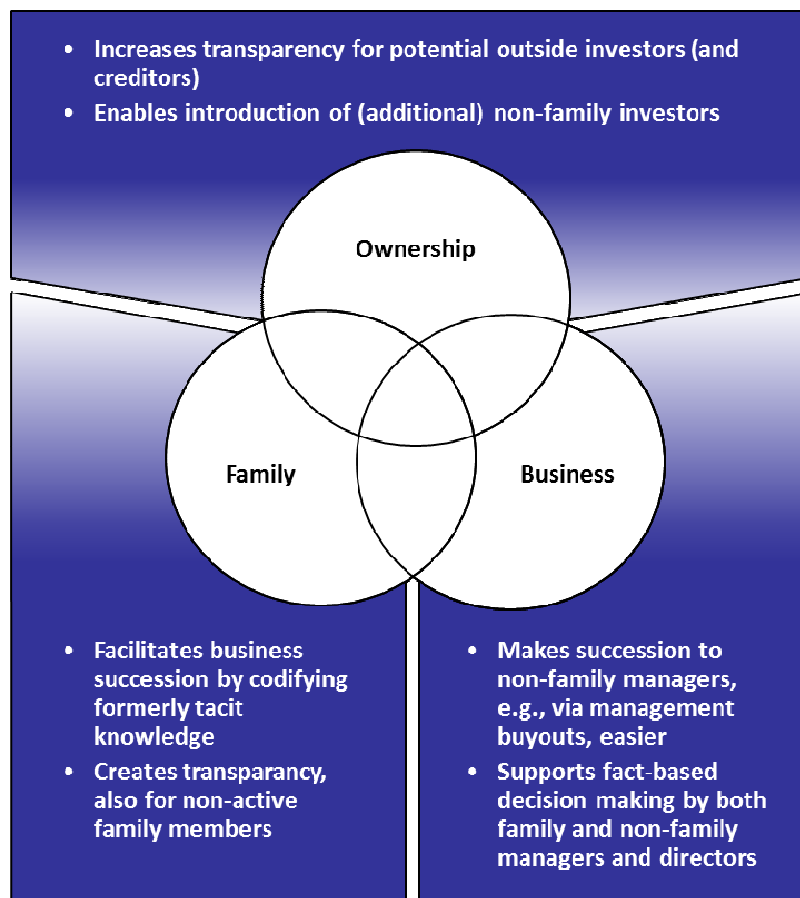
The concrete occasion when family businesses eventually opt for more formalisation and the introduction of management accounting practices could be the result of a sudden personnel change in management (caused by accidents, diseases or deaths) or could occur when succeeding family generations or non-family managers take over responsibility (Giovannoni *et al.,* 2011; Hiebl *et al.,* 2013) or could be the result of other radical changes. However, another possibility is that the family business does not even reach these turning points. Due to coordination problems, overlooked risks or investment failures, the family business might have failed already.

At any rate, the question that becomes evident is whether a family firm must take these chances and risk the existence of the firm or whether it should act earlier. The answer is simple: proactivity is also a viable option for family businesses. As outlined in section 1, such a proactive approach to using management accounting practices could help either to avoid the problems outlined above or to mitigate them. Therefore, the ingredients of this approach and the specific benefits to family businesses are discussed in the next section.

Family business-specific benefits of management accounting

A key characteristic of family businesses, compared to non-family businesses, is that in addition to the business and ownership sphere, the family sphere also decisively impacts family firms. Therefore, to depict this increased complexity, research has created the Three-Circle Model of family businesses. This model explains family businesses and their behaviours and peculiarities using three overlapping circles. These circles represent the three subsystems or key stakeholder groups (business, ownership and family) that make up the family business system (Gersick *et al.,* 1997). To demonstrate the family business-specific benefits of the (increased) usage of management accounting, these benefits are discussed regarding each of the three subsystems in the next three subsections. Figure 1 provides an overview of these benefits.

Figure 1. Benefits of Management Accounting for Key Stakeholder Groups in Family Businesses



Family benefits

Reconsidering the high mortality rate of family businesses outlined in section 1, it seems natural that one of the key concerns of family business owners is how they can successfully design business succession for subsequent generations (Chua *et al.,* 2003). One important ingredient of successful business successions is knowledge transfer. As noted above, knowledge transfer might be especially challenging for family businesses, as family managers usually rely to a high degree on tacit knowledge. One possible method to codify knowledge and to classify it uniformly is the use of management accounting or management control practices (Giovannoni *et al.,* 2011). For instance, when a family owner writes down (and therefore codifies) both the financial and non-financial goals of the family business for the next few years, the succeeding generations can more easily understand which strategic priorities the family manager has in mind. In practice, these financial and non-financial goals can also be broken down at the individual employee's level. Additionally, examining these individual goals could help succeeding generations to comprehend what each of the family firm's employees must contribute to reach the overall targets. This example might sound simple, but in many cases, family managers do not even consider that it might be valuable to share their visions of their firms with others, paradoxically including the family members who are destined to lead the business in the future (Giovannoni *et al.,* 2011). However, if these strategic priorities are codified, knowledge transfer and successful business succession should be facilitated.

The controlling family might also choose not to continue actively managing the firm but to engage non-family managers. Even in such cases, management accounting could be important for the family, as it can help to monitor non-family managers and to make their actions more transparent for the controlling family (Hiebl *et al.*, 2012). For example, using annual budgeting (a management accounting practice) creates one-year goals for non-family managers. Before the budgeted year, the family can set targets and therefore influence the budget and targeted earnings. After the respective year, the family can evaluate whether the non-family manager has reached the target or not and might even be able to judge why. At any rate, this process is not possible without management accountants or management accounting information. Moreover, the controlling family might also introduce incentive

mechanisms to align the non-family manager's behaviour to the family's goals. These incentive mechanisms typically also build upon management accounting information, and thus, these mechanisms are only available if the management accounting system provides sufficient information (Hiebl *et al.*, 2012). Again, this example might sound obvious, but this benefit is also only available if the family chooses to install institutions that provide the necessary information. Therefore, if the controlling family wants to prepare proactively for non-family management succession, it might consider introducing sufficient management accounting systems, which can provide the family with the tools to monitor non-family managers effectively and to align the managers' interests with the family's goals.

Ownership benefits

Yet another viable path for family business owners to exit "their" firms is to sell their shares to outside investors. This choice might be especially appropriate if there are no heirs who could take over the firm owner's equity stake or if the family firm owner believes that his or her heirs are not capable of effectively controlling or managing the family firm. In such situations, the family business owner (or a group of family members owning the firm) could certainly consider selling the business to non-family investors. Even in this situation of parting the family from the family business, the controlling family might be well advised to introduce a sufficient management accounting system before initiating the sale because potential outside investors usually require profound information about their purchase target, which certainly also includes numbers, as well as future plans and projects. Again, this type of information is likely only available if the family has introduced institutions to create this information beforehand. At any rate, such information might not only be necessary if the family sells all of its shares in the family firm but only sells a minority stake in the firm to outside investors. For instance, the introduction of outside investors might be necessary to fund growth projects or to enter new/foreign markets (González *et al.,* 2012). In such situations, the outside investors might not be willing to invest money without sufficient management accounting information. Moreover, institutional investors and venture capital firms usually require more formalised reporting and accounting information after their entry (Hiebl *et al.,* 2013). Therefore, no matter whether selling the family business entirely or keeping ownership rights in the firm, the family should consider setting up an

adequate management accounting system beforehand that can produce the required information.

The same argumentation should be valid for creditors, such as banks. This requirement is especially important to family businesses, as they usually prefer debt to equity financing for growth (González *et al.,* 2012). In this way, they aim not to allow their control rights in the family business to dilute. However, creditors are also unlikely to lend the family firm money without receiving regular updates on how the business is doing and how the numbers are developing. Again, these numbers and, in general, the information required by creditors should be produced by management accountants.

Business benefits

So far, this article has mainly shown the benefits to the owners of using management accounting in family businesses, either for current or future family and non-family owners. However, even for conducting business itself, proper usage of management accounting might add value to a family firm. The key feature of management accounting in this context is that it creates transparency. Used appropriately, management accounting information delivers *facts* for decision-making. The word "facts" is italicised, as in many family firms, decision-making is not solely based on facts but (also) on emotions (Sirmon and Hitt, 2003). Of course, decisions become entirely emotion-driven without fact-based information. Therefore, the presentation of facts derived from management accountants might constitute a first step towards more fact-based decisions. Clearly, fact-based decisions might not always lead to superior performance, but they could be perceived as reducing the risk of business failure (Gómez-Mejía *et al.,* 2007). Thus, for reducing the risk inherent in management decisions, management accounting information should be helpful.

Eventually, the knowledge-codifying character of management accounting information might also foster business continuity. If the family opts to retire from active family business management and to limit family involvement to a directorial role, the non-family employees or managers of the firm will be better equipped to create a smooth handover of management responsibility, if the family manager has explicated his or her plans and vision using management accounting practices (Giovannoni *et al.,* 2011). One management

accounting practice predestined for such purposes is the balanced scorecard, the specific importance of which for family businesses will be discussed in the following section.

Example management accounting practice: the balanced scorecard in family businesses

The concept of the balanced scorecard was introduced by Kaplan and Norton (1992) and was initially focused on the balance between financial and non-financial firm targets. It has since developed into the most discussed performance measurement and management tool in management accounting literature (Neely, 2005). One of the reasons for the balanced scorecard's success might be found in its inherent mechanism for translating strategies into actions. The key concept in this connection is that the overall strategy must be broken down into strategic goals for each (balanced) perspective, and concrete targets and measurements should be created to track goal achievement (Kaplan and Norton, 1992).

For family firms, the balanced scorecard could be especially useful, as it (1) forces family owners to codify their strategies and to set concrete goals and measurement, which make it easier for other family members and non-family members to understand the family manager's vision (2) and enable the family to balance traditional economic goals (e.g., earnings, profitability) with non-economic goals, which might include family-centred goals, such as "securing family-internal business succession". Thus, the process of implementing a balanced scorecard already leads to the above-described codification of formerly tacit family knowledge (Giovannoni *et al.,* 2011).

For the concrete design of the balanced scorecard, the family firm might choose between two similar approaches. The first would be to stick with the four classical balanced scorecard perspectives (financial, customer, innovation and learning and internal business processes) and add family-specific objectives, measurement and targets to each (or perhaps only the appropriate) perspective. For instance, a family-centred goal in the "innovation and learning" perspective might be to provide attractive jobs to family members who wish to work in the family business. The second approach would be to add a fifth perspective to the

classical four balanced scorecard perspectives [1], which bundles all of the family issues. Goals might include deploying only a certain amount of earnings to family shareholders, maintaining a family council to facilitate internal processes or continuing to be perceived by customers as a family business (Craig and Moores, 2005). Either way, using the balanced scorecard, the family will be able to integrate adequately the three subsystems (business, ownership and family) of the family business system into one consistent performance measurement system and to equip itself with both knowledge-sharing and strategy-operationalising tools.

Conclusions

This article has shown how family businesses can benefit from taking a proactive approach to using management accounting practices. This choice should lead to benefits for all three subsystems of the family business system: business, ownership and family. Therefore, the controlling family can prepare for family and non-family business succession, the integration of non-family investors and the creation of a more fact-based decision-making culture.

Family owners might now raise the question of where to start if they have so far neglected the possibility of using management accounting practices. Although there is certainly no "one size fits all" approach to this question, starting small and then increasing the intensity of management accounting should be useful. Specifically, such an approach would mean starting at the short-term level by setting one-year targets and plans and introducing annual budgeting. If these steps work, the family firm might enlarge its planning horizon to three- to five-year periods. The targets for these longer periods of time might already be derived from a balanced scorecard approach. Eventually, introducing some key performance indicators for non-economic measurement of success (e.g., idle time, number of ill staff, customer retention and customer satisfaction) might be a worthwhile addition to the basic management accounting system. However, for each practice, it is crucial not simply to implement the first step (e.g., develop the plan) but also to measure results against the set targets and act in a timely manner if the targets are not met. In addition, the repeated use of management accounting practices should also be used to derive valuable information for the

next cycle, which might help, for instance, to speed up the planning process. Adhering to these simple recommendations should leave the family firm better equipped for major operational and strategic challenges.

Notes

[1] The number of perspectives is not necessarily limited to four. Rather, firms should choose the number of perspectives that best reflects their business and is still easily overlooked.

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