FAMILY GOVERNANCE OF FAMILY FIRMS [†]

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ABSTRACT

Research in corporate governance has mostly been concerned with listed corporations with a large separation between ownership and control, a condition that has formed the theories developed in the area. We focus on the family firm, which differs from the listed corporations in many respects, since it has specific family firm characteristics, i.e., modest separation between ownership and control, the presence of non-financial goals, a long-term perspective and an active ownership function. These specific circumstances imply that the corporate governance is different in these firms, including the form and function of the different governance mechanisms. We take a governance strategy approach that stresses the principals' role in the governance of the firm, and apply this on the family firm, acknowledging its special characteristics. We develop propositions concerning four of the governance mechanisms, namely the board of directors, the capital structure, the incentive system and the audit/the auditor. We conclude that the functioning of the governance mechanisms not only depend on the firm's conditions, but also the family's. For example, the capital structure is proposed to reflect the financial conditions of both the family and the firm, as well as the family's risk bearing and its relationships to important stakeholders.

INTRODUCTION

Marx regarded the corporations as the realization of capitalism, where the sentiments and risk avoidance of the single owner were superseded by employed rational managers. Adam Smith believed in the single entrepreneur and the ability to survive through supplying bread to the market. In between the firm characterized by full separation of ownership and control and the single entrepreneur's firm without such a separation is the family firm. While the Smithsonian entrepreneur has received a lot of attention in the field of entrepreneurship, the Marxian corporation with fully realized separation of ownership and control has been focused in the field of corporate governance. The firm in-between, the family firm, has been almost forgotten until the end of the 1990's, and since then we have witnessed a strong development of the family business research field.

The characteristics of the family firm differ from those of the listed corporations that mostly have been studied in corporate governance, where the characteristics are a highly dispersed ownership structure, a high exposure towards rather efficient markets, for example the stock market, and a domination of professional management. Corporate governance has therefore developed a conception of the owner following the Veblenian conception of absentee ownership. Through taking the special characteristics of the family firm into consideration, this organizational form offers opportunities to develop the conception of corporate governance. What characterizes a family firm are among others things an active ownership where family members are active in management and at the board of directors (Lane, Astrachan, Keyt & MacMillan, 2006), implying a modest separation between ownership and control. This is a prevalent trait not only in SMEs, but also in listed corporations, where it is common that families that are controlling owners are represented in the management of the firm (La Porta, Lopez-De-Silanes & Shleifer, 1999). Other characteristics that are often attributed to the family firm are a long-term perspective (e.g. Lane et al, 2006) and the existence of other goals than financial ones (e.g. Zellweger, Nason, Nordqvist & Brush, 2011).

The efficiency of family ownership has been much discussed. For a recent review of pros and cons of family firms, see Gedajlovic, Carney, Chrisman and Kellermanns (2012). The family firm has for example been claimed to be inefficient due to its family character, having lower capital spending, less investments, excessive liquidity, lower productivity, lower innovativeness, under-investments in emerging technologies, poor decision making by family managers, greater managerial entrenchment, favouring family members, limited by family traditions, less active market for corporate control, limited managerial labour market and weaker compensation system to executives (Anderson and Reeb, 2004; Schulze, Lubatkin, Dino and Buchholtz, 2001). These deficiencies are balanced by the family's long-term investment horizon and long-term performance objectives, the strong ownership function created through a concentrated ownership structure, loyalty and trust, with owners having insight in the business and with historical knowledge, therefore also being strong in monitoring capacity (Braun and Sharma, 2007; Miller and Le Breton-Miller, 2006).

While studies of family firms have observed single corporate governance mechanisms and included some of the specificities of family firms, we would like to propose an integrated conception of family firm governance through the concept of governance strategy. Through applying the concept of governance strategy, where the principal's influence on the firm through the use of the governance mechanisms is stressed, we will study the family firm, taking into consideration it's special characteristics and what that purports for its governance.

The aim of this paper is to explore the family's corporate governance of the family firm, which we term family governance. By doing this we contribute to corporate governance research through focusing on an organizational form seldom noticed in this field, and by focusing on the family we could add new insights to the functioning of the governance mechanisms. We also contribute to the conception of the family firm through interpreting phenomena noted in previous research as indications of the presence of a governance strategy from the family's side.

Our method is to make use of the concept of governance strategy (Collin, 2007). It was originally developed in order to contrast with the dominant perspective in the corporate governance literature, i.e., large, listed US-firms, i.e., active agents, mainly managers, acting on behalf of passive principals, i.e., the owners/shareholders (Jensen & Meckling, 1976). The conception of governance strategy is more in line with European experiences and traditions (Grandori, 2004; Huse, 2007), stressing the intentional part of governance (Demsetz & Lehn, 1985), where an actor of governance, i.e., the principal, uses the set of corporate governance mechanisms in order to influence the agent to create a performance that will satisfy the interest of the principal. These features resemble much of the characteristics of family firms found in the literature. Thus, the conception of governance strategy appears to be able to create an integrated conception of family governance. The paper is our effort to expound this conception.

The paper continues with the definition of family governance strategy and how it is based on family firm characteristics. Then we show the implications of the conception through applying it on four governance mechanisms, the capital structure, the compensation system, the board of directors and the audit and the auditor, where we show the relevance of the conception through deriving propositions that can be tested as hypotheses. We conclude by stressing that governance strategy implies that there is a mutual dependency between the owner, i.e., the family, and the subject to be governed, i.e., the family firm, making it hard to understand family governance without simultaneously considering both the firm and the family.

GOVERNANCE STRATEGY OF THE FAMILY FIRM

Corporate governance (CG) can be defined as a set of mechanisms that supports the fulfilment of the will of the principal. This set consists of capital (both equity and debt), managerial labour selected from the external or the internal managerial labour market, executive compensation, the board of directors, the strategy and structure of the organisation, the auditors, and the environment (cf. Schleifer & Vishny, 1997). These mechanisms have been explored in firms with active agents, mainly managers, acting on behalf of passive principals, i.e., the owners/shareholders (Jensen & Meckling, 1976). We use a more praxis oriented conception where the principal is not only active but also puts a mark on the firm in many respects. This is the concept of governance strategy (Collin, 2007). This concept is based on a property right approach (Asher, Mahoney, & Mahoney, 2005) and derived within the context of agency theory, stressing the interest and capacity of the principal. The concept is illustrated in Figure 1 below:

Insert Figure 1 about here

Summarising the model, it says that the set-up of corporate governance mechanisms is influenced by exogenous factors, such as the property rights setup and the market structure, but also by the agent and the principal. The principal, depending on its capacity and interest, can make a conscious choice of taking control of the leeway of every corporate governance mechanism and the mix of the mechanisms. This is the creation of the governance strategy, which will influence the organisation's capacity to create a performance through corporate strategy implementation and strategic opportunism. The strength of the concept is that it can identify the actions of the principal and can consider the interaction of the different mechanisms, in contrast with the singular treatment of the governance mechanisms, focusing on e.g., the board (Huse, 2007) or the ownership structure (Demsetz & Lehn, 1985).

The main principal of the family firm, the family which upholds the controlling ownership of the firm, is rather specific. Typically, the family firm starts as a Smithsonian entrepreneurial firm (cf. Gersick, Davis, McCollom Hampton & Lansberg, 1997). During this stage, it becomes clear if it will turn into a family firm or if it is going to be sold to other investors. After the first succession it's family character appears more clearly.

The family firm has certain characteristics that we believe are important from the corporate governance point of view, since it stands in contrast with the firms normally studied in the field of corporate governance. Indeed, as Le Breton-Miller & Miller (2008:43) say "A family business is said to represent to a family a key socio-emotional endowment – a corporate entity that embodies the hopes and is designed to fulfill the needs of the family.", which brings about special circumstances concerning the governance of these firms. We list the characteristics of the family firm in table 1, organised according to if they are premises or intentions, actions performed or consequences.

Insert Table 1 about here

Family firm characteristics with reference to intentions and premises are: 1. The firm is a mean for the family, i.e., that the firm is driven by the intention to be governed by and to give support to a collection of individuals that are tied together by kinship relationships (cf. Le Breton-Miller & Miller, 2008); 2. It has financial goals mainly in order to be able to develop the firm and to give support to the family, but another overriding goal could be the non-financial goal of survival, in order to be able to transfer the firm to the next generation; 3. The family firm is transferred between generations, which creates continuity but also disruptive changes at each generational transfer and a risk of dilution of the family consensus (cf. Bammens, Voordeckers & Van Gils, 2008; Lubatkin, Schulze, Ling & Dino, 2005).

The family characteristics with reference to actions are: 1. that the actions performed represent more a concern for the interest of controlling the firm than creating profit maximization, since the aim of the firm is to govern it in order to transfer it to the next generation; 2. Relationships are sought that can support the interest of transfer of the firm, which implies a tendency for long-term relationships with important stakeholders (cf. Le Breton-Miller, Miller & Lester, 2011); 3. The transfer of the firm being an important goal, it creates a perspective in actions guided by a long term perspective (cf. Lane et al, 2006).

Family firm characteristics with reference to consequences of the intentions and actions are: The stakeholders experience low risk in their exchange due to the actions of long term perspective and relationships; 2. The border between the family and the firm is ambiguous because the firm is a mean for the family, where the family penetrates the firm, both through their governance, management and as employees of the firm. But, at the same time there could be a tendency that this ‘mean’ view becomes converted into a feeling among family members that the family is instead a mean for the firm; 3. All in all, with these intentions and these actions and consequences, the firm tends to be subject to a strong governance strategy.

We will now argue for and show how these three groups of family firm characteristics influence the formation of a governance strategy. The specifics with the family governance are that the family has, at least in the early generational stages, a high capacity and a strong interest in the future of the firm. This makes the governance strategy rather easy to identify, not only by researchers but also by stakeholders, such as employees and creditors. Thus, one characteristic consequence, at least in the early stages, is low risk for stakeholders, if compared to a firm with weaker owners.

The capacity and strength of the interest is due to the firm-specific investments the family is doing in the firm, emphasising control and long-term perspective, and the dependency on the family experience. The family owner of the family firm is characterised, at least in the early generational phases, by high level of information, high competence and low governance costs. With the long term perspective, the family has been engaged in the firm for generations, thus building information networks and experience from many years of the business and the firm. At the same time, the wholehearted engagement in the family firm and the typically dominating ownership, and very often participation at the board, the top management team and even further down in the hierarchy, makes the costs of invention small, i.e., low governance costs. These low costs are conducive in supporting a strong family governance strategy.

The high level of engagement and participation creates another feature of family governance, which is the ambiguous border between the family and the firm. As we will argue later, it can be discernable through such phenomena as a floating line between debt and equity, and an unclear location of the functions of the board. The floating border creates the character of the family firm being penetrated by the family. From the point of view of the firm it implies strong monitoring capacity, as well as directing the firm through strategy, which has been found to be a strong governance mechanism in municipal corporations (Collin & Tagesson, 2010).

Another specific characteristic of family governance is that the ownership is transferred between generations, which tend to change the characteristics of the family governance. Passing through many generational transfers, the ownership could become more diluted, and the tensions between the different parts of the family could then increase since different family branches then could come to identify more with the own branch than the whole family, and thus create their own, independent ideas about the future of the corporation and have less loyalty towards the firm (e.g. Bammens, Voordeckers & Van Gils, 2008; Davis & Harveston, 2001; Lubatkin, Schulze, Ling & Dino, 2005). A family ownership with these characteristics slowly passes from a strong governance strategy to a strategy that may not even be coherent due to the conflicts between the different parts of the extended family.

These characteristics and their consequences for the governance mechanisms contrast sharply to the typical US-listed firm, where the owners, typically funds, have weak information concerning the specificities of the firm, low level of competence due to a low level of knowledge and experience of the business and the firm, and with rather high costs of governance, restricting them to, at most, engagement at the shareholder meeting.

With these contrasts, it could be expected that propositions concerning family firm governance would differ substantially from the ordinary governance propositions made based on conceptions of a US-listed corporation. We will here explore four mechanisms through these family firm characteristics and argue for a number of propositions which will indicate that the governance strategy of a family firm differs due to the specific characteristics of the family firm. We will focus on four mechanisms, which by no means is an evaluation of their importance. Instead we focus on those mechanisms that we think have received the least attention in the family firm research. They are the capital structure, the compensation system, the board of directors and the auditors of the family firm.

THE CAPITAL STRUCTURE OF THE FAMILY FIRM

The capital structure of firms has been explained by pecking-order theory (Myers, 1984) but also by trade-off theory (Kraus & Litzenberger, 1973) and agency theory (Jensen & Meckling, 1976). Empirically it has been found that the capital structure is influenced by the size of the corporation, and thereby it’s access to the capital market, the industry, which determines it’s business risk, and the financial effectiveness of the firm.

In the literature of corporate governance, the financial structure is first and foremost considered to be a governance mechanism, where high levels of debt submit managers to a strong pressure to perform. In family firms, high levels of debt cannot be expected since it creates dependency towards debt holders, and therefore put a threat to the autonomy of the family (Rutherford, Kuratko & Holt, 2008) and the family’s control of the firm. Family firms would therefore, ceteris paribus, be expected to have lower leverage than comparable firms without family control.

Family firms have lower leverage than non-family firms

While this is the normal prediction, it could be adjusted to some specific situations. Family firms, due to stable governance structures over time, have an opportunity to build long-term relationships with its stakeholders, e.g. banks (e.g. Steijvers & Voordeckers, 2009). When concerning debt holders, especially banks, the family firm could build a long-term relationship characterised by trust and honour, where the evaluation by the bank is made not only on the project but also, and foremost, on the family and the trust the bank has towards the family, i.e., the credibility of the family. In the case a long-term relationship between the family and the banks exists, it could purport that even higher levels of loans at a specific bank are not considered as being a treat to the autonomy of the family. Thus, we could expect length of relationship with a specific bank to increase the leverage of the family firm.

Lengthy relationships with specific debt holders increase the leverage of the family firm

Another situation that can influence the capital structure of the family firm is when one distinguishes between the specific types of debts. It has been found that family firms tend to have higher levels of short term debts than long term debts. While long term debt is related to the financial activities of the firm, short term debt tends to be related to the commercial activities of the corporation, mainly supplier debts. It could be the case, as with the bank, that family firms have stable relationships with suppliers, maybe supported by family relationships between the two firms that make it possible for them to have more favourable debt conditions with suppliers, which leads to the proposition that:

Family firms have higher levels of short term debt than non-family firms

The capital structure could also be influenced by the generational stage of the family firm. When more generations have passed, the family is bigger and thereby puts higher pressure on dividends (e.g. Ward, 1987), and the characteristics of family firm will be reduced, thus reducing the tendency to preserve autonomy, with increasing leverage as a consequence. On the other hand, the trust relationship to the debt holders, for example specific banks, could be eroded since the founder and the subsequent generation is not present anymore and a more faceless big family is governing the firm, with reduced credibility as a consequence. This will counteract the pressure to increasing levels of leverage and put the firm closer to the risk of financial stress. Molly, Laveren and Deloof (2010) have found the leverage to be reduced in second generation and then to increase. It could be interpreted as the high risk attitude of the founder entrepreneur will be exchanged with the family firm attitude of low financial risk, which then is surpassed by the expanding family's demand on dividends and weaker family firm values of autonomy.

Family firms' leverage increases by generational stage

The capital structure is also influenced by the financial conditions of the family. Romano, Tanewski & Smyrnios (2000) found that part of the long term loans in the firm where given by the family. This is part of the ambiguous border between the firm and the family, implying that the separation between debt and equity is fuzzy in family firms. This has implications for our conception of firm risk. Normally we assume that we can separate the risk of the firm into the risk created by being part of a business, i.e., business risk, and the financial risk, typically conceptualised as leverage. With family firms we have to acknowledge the fact that the financial situation of the family could influence the firm, through for example pressure on dividend and long term loans to the firm. Thus we propose to add family risk, which is the financial pressure and opportunities put on the firm by the family and its financial conditions.

The family firm risk is influenced by the business risk, the financial risk and the family risk

To summarize, we propose that the capital structure and the dividend policy are influenced by a combination of firm and family considerations, including control considerations, the generational phase of the family firm and the long term relationships, thus stressing the ambiguous border between the family and the firm.

THE COMPENSATION SYSTEM IN THE FAMILY FIRM

The function of the compensation system is to guide human behaviour through incentives and thereby implement the interest of the principal (Gomez-Mejia & Wiseman, 1997). There are specific conditions for compensation systems in family firms. Research has observed that it can be burden by nepotism (Lubatkin, Schulze, Ling & Dino, 2005), but that the compensation scheme is less oriented towards dealing with agency costs since the family has superior monitoring capacity. The specificities of a family firm cannot be too extreme since the family firm has to compete in the market for managerial labour with non-family firms in order to recruit and retain managers (Klein & Bell, 2007).

Many studies of compensation systems in family firms have been on listed corporation (i.e., Chourou, 2010; Combs, Penney, Crook & Short, 2010; Gomez-Mejia, Larazza-Kintana & Makri, 2003). In a study of listed Swedish corporations it was found that corporations that were classified as controlled by a family paid lower levels of compensation to the CEO and had a tendency to use option schemes to a lower degree (Collin, Gustafsson, Petersson & Smith, 2009). These results could be explained by family owners having stronger capacity to monitor, and that options or shares would reduce the ownership of the family, and thereby the control. This tendency, especially the usage of options, has to be controlled for culture since it tends to be a tradition in US and UK to use option schemes, while in most other industrialized countries, the usage of options is much more varied.

It has also been found that the compensation levels lower down in the hierarchy of the firm are lower than comparable non-family firms (Carrasco-Hernandez & Sánchez-Marín, 2007). There are also indications that a family CEO has lower compensation than a non-family CEO in family firms (Gomez-Mejia et al, 2003). Thus, we have reasons to propose:

Family control is negatively correlated with CEO compensation

Family control is negatively correlated with propensity to use option schemes

The ambiguous border between the family and the firm also includes the compensation scheme. A family can regulate the cash flow of the firm, and therefore the capital through the compensation scheme. If in power, the family could decide to increase or decrease the burden on the cash flow through paying more or less to family members. The needs of the firm will be considered simultaneously with the needs of the family members that are working or having stocks in the firm.

The compensation to family members is a function of the needs of the firm and the needs of the family members

Concerning employees outside the family, this balancing of cash flow needs would presumably not be present. The reason is that non-family employees are more subject to the competition on the managerial labour market and because non-family employees do not gain anything specific by letting cash be accumulated in the firm instead of being paid as salary. However, this could be adjusted since the compensation system could be different in one important respect. A family firm could be assumed to tie the compensation less to the profitability of the firm, or even to the performance of the individual. The risk of down-turn and the risk of temporarily drop in individual performance could then be borne by the family. Thus, family firms could have a different risk distribution through the compensation system, reducing the risk of the employee, at the price of lower compensation. This behaviour could be based on paternalistic inclinations by the family. Additionally, as suggested by Klein and Bell (2007) family firms could use other forms of compensation, such as emotional and social rewards. Thus, we offer the following proposition:

The compensation to employees is lower and less risky in family firms compared to non-family firms

One reason that can be suggested for family members' lower compensation is that they can be subject to very strong sanctions, such as exclusion from the family circle. To be fired is of course a strong sanction also for non-family members, but they have other corporations to join, while the family member only has one family. Thus, sanctions, such as exclusion, could be more motivating than incentives for family members. Finally, one motivating force that family members could have, but not non-family members, is the duty to support the family firm, with labour, capital and other forms of resources. A family member could be asked to perform the duty, which by definition of duty cannot be compensated, since duty is without consequences. But for the firm, this deontic behaviour has the consequence that salaries can be kept low. All in all, if anything, we would propose that family members would gain less in a family firm.

Family members employed in a family firm have more variable rewards than non-family members

This prediction could be concurred by the notion that family firms are defined by nepotism, i.e., that family members are treated with preference, irrespective of their individual performance.

Lubatkin, Schulze, Ling & Dino (2005) consider nepotism as the dark side of the family firm and suggest that nepotism reduces the motivation for non-family members. Nepotism, they claim, is demoralising and reduces incentives since certain positions can be dedicated to only family members. This demoralising argument can be criticised and demands more empirical studies, since it assumes that employees in a family firm do not separate their conception of justice between family members and non-family members. It could be argued that the family institution in most cultures contains the notion of nepotism and that nepotism in family firms is accepted, and therefore not considered to be unjust. The other part of their argument, that certain positions are dedicated for family members is more likely to reduce the incentives among employees. But that is very similar to homo social reproduction, that certain types of persons are preferred and get promotion more easily, the glass ceiling being the most studied one. Finally, to have certain positions dedicated to family members could be an effort to sustain the familiness of the family firm, thus constituting a mean to uphold a competitive advantage gained through the family character. Thus, we propose:

Positions dedicated to family members is a mean to uphold the familiness of the firm

To summarize, we believe that the compensation system is characterized by the ambiguous border between the family and the firm, implying that family members in the firm are compensated differently than non-family members, which could have incentive effects. It is however hard to make an evaluation of the incentive effects and whether they have a positive or negative impact on the firm’s effectiveness at this level of theoretical development.

THE BOARD OF DIRECTORS IN THE FAMILY FIRM

The board of directors has attracted considerable attention, both in popular press and in science. This also accounts for the family firm board. It has, however, been doomed by very strong judgements where the board most commonly has been said to be unimportant or incompetent, mainly because of the total dominance of family members as directors (for an overview, see van den Heuvel, Van Gils & Voordeckers, 2006; but also Corbetta & Tomaselli, 1996; Ward & Handy, 1988; Nash, 1988; Miller & Le Breton-Miller, 2006; Schulze, Lubatkin, Dino & Buchholtz, 2001). In the era of the ideology of so called 'good governance', there is a normative belief that boards of directors should consist of independent directors. The family firm board is here a contradiction which does not pay due respect to modern corporate governance ideology. One may then ask the question why so many family firms do not obey the modern ideology.

Simultaneously, the board of directors link the family and firm together, and already Ward and Handy (1988) mention that this is the place that is most likely for family, management and ownership to meet. Taking that into consideration, the board can be one way to govern the family firm on behalf of the owners, even if it consists of family members. Concerning the functions of the board, the family firm board has been suggested to have the functions that non-family firms have, but some more functions have also been acknowledged (Brunninge & Nordqvist, 2004). Taking a governance strategy approach, we propose that it is important to consider the functions that can be specific for family firms to capture the characteristics of the family firm. The functions of the board has to some extent been researched before, but according to Bammens Voordeckers and Van Gils (2011), the board functions of control and advice have then been in focus, and often researchers have focused at one of them at expense of the other.

Going back to the functions that have been proposed as being possible in family firms, Corbetta and Tomaselli (1996) mention succession planning, and Neubauer and Lank (1998) say that the next generation of family members can be groomed into the business on family meetings where the firm is discussed, but they do not restrict this to the board. Corbetta and Tomaselli (1996:404) further refer to the board as “enabling the family to become more familiar with the firm”. It has been suggested that there exist several ideal types of family firm boards where the board has different functions and therefore different tasks as well as mandates (Collin, Ahlberg & Gabrielsson 2010). One ideal typical board is the training camp, where the board consists mainly of younger family members. They are at the board in order to learn the business and the corporation, preparing for generational transfer. Such a board becomes naturally passive, and contains few if any directors from outside the family. This board can appear to be non-functional for the supporter of ‘good governance’ ideology. But it could very well be a conscious part of the family’s governance strategy. The composition of the board is not due to the legal responsibility of the board, or to fulfil the traditional functions of the board, such as monitoring, decision making, service or conflict resolution (Collin, 2008). The composition is instead made in order to train and socialize the next generation into the firm, its business, its traditions and its strategy.

The family firm characteristics are in this way manifested at the board level, indicating the ambiguous border between the firm and the family, where the low level of separation between ownership and control is part of the character. At the same time, is can display traces of the family’s governance strategy, where we argue that the choice of family members as directors can be fully in line with the family’s strategy for the firm and the family taken together.

Another ideal type of family board is the battle ground board, which is a board dominated by cousins or even less related family members. This board is characterized by conflicts and by the ambition to perform the function of conflict resolution, since it has less to do with the firm, and more to deal with different parts of the extended family and their conflictual interests. In this board, independent directors could be expected to perform a similar function that the auditor could perform, that of being a Consigliere at the board with the functions of bringing advice and to mediate the conflicts of the family members. We will return to the function of Consigliere in the subsequent section about the auditor, where we will develop the conception more.

With this conception, an independent director would have a genuine relation to the family, thus not being truly independent since the director is supposed to be carrier of the tradition in order to be able to mediate conflicts. The independent director is, as a Consigliere, without any blood relationship, and in this sense independent of family interest. Thus, we propose that:

The composition and functions of the board of directors reflect the governance strategy of the family

An independent director could perform the function of Consigliere

We would also like to add that the board of directors exists first and foremost because it is a legal requirement. It is an institution that the legislators have found as a suitable mean for corporate governance, but it is necessarily not suitable for the family's governance of the family firm. This is in line with the suggestion made by Lane et al (2006), who mention that companies other than the large listed corporations with a large separation of ownership and control may have other needs, and legislation adjusted to the listed corporations may therefore not suit them. A board is the delegated owners of the firm, with an increase in importance as the absenteeism of the owners increase. In many family firms, with low levels of absenteeism and an ambiguous border between the family and the firm, the functions of the board are not that distinctive. It could very well be the case that the functions of the board are carried out outside the formal board, in arenas that the family finds more adequate. This would be possible due to the ambiguous border between the family and the firm, which opens the possibility for the family to use other arenas than the formal board of directors for their governance, since they possibly meet at other occasions as well (cf. Nordqvist, 2005). In Sweden, the dinners at 'Täcka Udden' have been famous. At 'Täcka Udden' the pater of the Wallenberg family had his residence, and CEOs and directors from the different corporations belonging to the family business groups lined up for dinners. These dinners can be assumed, since we do not have any systematic research made on them, to perform part of functions normally performed by the corporations' boards. Thus, in order to find the functions of the board when studying family firms, we have to find the right arena, which cannot be assumed to be the board room. Thus, we propose the following conception:

The functions of the board are performed at many arenas of the family, the board room being but one.

It could also be the case that part of the family is the main governing body of the firm, other parts of the family being of less importance, with less engagement. Therefore a board can consists of subgroups (Smith, 2007), where the power is situated in one group and the more overlooking, informative function is performed by other parts of the board.

The family firm board could be fragmented into subgroups, performing different functions for the family

To summarize, we proposed that the board is part of the family governance of the family firm, implying that its activities and the functions performed by the board can be explained by the needs of the firm and the family taken together. We have even suggested that the board, no matter its legal definition and responsibilities, is a function of the family governance, implying that legal functions of the board could be performed outside the board.

THE AUDIT AND AUDITOR OF THE FAMILY FIRM

The function of the audit and the auditor is to create trust in the information from the corporation through financial audit and, in Sweden and Finland, to perform a management audit and to suggest grant of discharge for the board of directors. Interestingly enough, this is an activity that has been fairly well studied in listed corporations, but with no special emphasis on family firms. Salvato & Moores (2010) found only 6 published studies on auditing in family firms, and among them only 4 that hade empirical content. Does this reflect that audit is of no specific concern in family firms? The opposite could be argued.

The audit function could be claimed to represent an owner’s eye within the firm. This eye could be expected to be of more importance when the owner is separated from the firm. In family firms this happens when the CEO and directors on the board are recruited outside the family. In national systems (Australia) where the voluntary audit is more extensive, the inclination to employ an auditor increases when management is left to non-family members and when capital to a greater extent is collected outside the family (Carey, Simnett & Tanewski, 2000).

In systems with audit obligation (Finland), the choice is mainly between the big audit firms, with high level of reputation for carrying high levels of audit quality, but also presumably higher audit fees, and smaller and local audit firms. The large audit firms are preferred when there is a decrease in family ownership of the family firm (Niskanen, Karjalainen & Niskanen, 2010).

It appears, from these two studies, that when the family is withdrawing from management, losing contact with the direct flow of internal information, they need to secure the information they get, which will be the function of the auditor. Additionally, when other stakeholders are invited, presumably debt and equity holders, the stakeholders, presumably not engaged in a manner that gives them direct access to privileged information, are asking for higher levels of audit quality, or the family assumes a bonding cost through engaging a more reputational auditor. Finally, when inviting directors from outside the family, the independent directors presumably ask for more secure information in order to be able to fulfil the duty of an independent director, thus pushing for audit quality. Thus, we make the following proposition:

The usage of audit/the level of audit quality is higher in family firms where the family is not engaged in the management of the family firm

The usage of audit/the level of audit quality increases when other stakeholders increase their influence in the family firm

The usage of audit/the level of audit quality is higher in family firms when the board has non-family directors

The information given from the firm from the accounting system appears to also be influenced by characteristics of the family firm. While it is commonly assumed and there are empirical indications that earnings management is less prevalent among family firms, the level of earnings management can be assumed to increase when the firm is listed and the ownership is shared with non-family members. The discussion about this phenomena concerns whether earnings management is caused by entrenchment of the family or to maintain long-term alignment and trust (Trotman & Trotman, 2010).

The level of earnings management increases when the family reduces their influence over the family firm

When inspecting the audit process, another distinctive character of the family firm could appear. While we have some indications that family firms prefer local audit firms and that they very seldom change auditor, we can assume that the relationship between the auditor and the firm is long-term, i.e., auditors have a long tenure as auditors. In family firms it can be assumed that the selection of the auditor is made by the family, not only formally, as in listed corporations through the shareholders general meetings decision, but also in selecting and proposing the auditor. Thus, we expect to find an almost personal relationship between the auditor and the head of the family. This creates a triangle of relationships, between the auditor, the family owners and the auditee (Salvato & Moores, 2010), but with some specificities.

One specific feature is that not only do the auditee and the board get information, but also the family can be expected to receive more information than the standardised auditor's report will give. Another specific feature is that the close relationship with the owner will give the auditor more information, making it easier to estimate the audit risk and the business risk. While the close relationship would put audit quality at risk due to risk of dependency, the improved possibility to estimate audit risk and business risk would presumably increase audit quality. Thus, we cannot make a prediction of more or less audit quality due to the characteristics of the triangular relationship of audit.

If the family firm prefers long-term relationship with the auditor and seldom changes the auditor, then we can even imagine that the audit task could be inherited within the same audit firm. Thus, we get an image of a close relationship between the local audit firm and the family firm, based on a relationship that stretches over several generations. In the case of a tradition inherited from one generation to another, this tradition would be known by the auditor, and thus the auditor would be as much a carrier of the tradition as the family members. If this is the case, we would propose a specific function for the auditor, that of the Consigliere. Over generations trust is created between the auditor, the audit firm and the firm and the family. While family members inherit the firm, auditors from the audit firm inherit the task of audit. Thus, the tradition of the family firm is also carried by the auditor.

What happens in the family firm is that the family members increase in number through the generational phases, implying an increasing potential for conflicts and distrust. The auditor as a Consigliere can then, based on insights earned from long term auditing of the firm, and knowledge about the tradition, function as a mediator between the conflicting parties. The family members can trust the auditor since the auditor does not have any blood relationship and has the professional pride of an auditor, thus being independent, but at the same time well acquainted with the family, the firm and the traditions.

In popular movies and novels, Consigliere is a person who has the right to tell the truth, to makes advice to the head of the family, who mediate conflicts within the family and performs operations as a representative of the head of the family. It is a person that can be trusted to perform with the interest of the whole family, and not the single fractions or individuals since the Consigliere lacks blood relationships. In our conception of the Consigliere, all functions except for the operational actions are included. To be operative is excluded in the auditor's case due to legislation and auditor custom. In our argument the auditor's function as a Consigliere will increase with generational phase due to presumably higher levels of conflict with increasing number of family members, and with more distant family members.

The auditor's function as Consigliere increases with generational phase

To summarize, due to the characteristics of the family firm, the auditor will become a more integrated part of the family firm and the family during the generational phases. While it could decrease audit quality due to dependencies, it could also be expected to increase audit quality due to more information about the firm.

CONCLUSIONS

The family firm differs from the highly studied listed firm in many respects. Due to its nepotism and overall its familiness, some have claimed it to be an organizational form of low effectiveness due to low capitalistic rationality, Marx being the most prominent among these researchers. Others, such as Jensen, have claimed that family firms are highly efficient, due to their strong monitoring capacity. In order to be able to bring more light on this issue instead of keeping it in the darkness of simple statements, we need to develop our understanding of the family firm in general, and how the family influences it through its governance strategy, thereby creating conditions for discipline and development of the firm. Our suggestion for a conception for this ambition was governance strategy.

With the governance strategy concept combined with a conception of family firm characteristics, we have analyzed four governance mechanisms in order to be able to make predictions about the design of these mechanisms. In many respects, due to the family firm characteristics, the mechanisms differ in design compared to the listed corporation. We found that the capital structure of the family firm reflects the owners, and their relationships to important stakeholders. Thus, it appears that it is not possible to explain the family firm capital structure by solely focusing on the firm and its business risk and financial risk, which is the traditional conception, but one also has to include the family and its relationships to important stakeholders. Thus, we cannot expect to find the agency implication of high leverage in order to control the managers and to reap the WACC benefits of debt.

We found that the compensation system is probably less related to the actual individual performance when it concerns family members, and less subject to the firm's risk when it concerns the employees. While less risk exposure would be expected to create loyalty and higher levels of firm specific investments, it could also imply a weaker pressure to perform. The compensation to family members that does not vary with individual performance, both in terms of financial resources and positions, would be expected to influence employees dependent on the view held by the employees. Thus, it could be the case that a culture of familiness where employees are credibly protected from firm risk could create an acceptance of family compensation, where risk of the firm and family influence justify the family members' compensation. Nepotism could therefore not be expected to imply negative incentive effects, but has to be moderated by the culture of familiness of the firm.

We found that the board of directors could be conceptualised as a true mean for the family, where even the legal regulation is submitted to the family interest and governance strategy. The strong condemnations made by researchers about the strange behaviour and composition of family firms' boards could instead be informed choices according to our analysis, indicating that the board is a legal creation that is remodelled in the family firm in accordance to the needs of the family, i.e., being a part of the family governance.

We found that the auditor becomes more engaged in the family firm and becomes a more important party when the family becomes weaker. In this sense one could argue that the auditor becomes a counterbalancing force in a governance strategy. When the family retreats, the auditor advances.

One of the most important contributions in our derivations is the idea that both the auditor and the independent director could have the function of a Consigliere. This function mainly means to mediate between family branches, without being suspected for blood considerations, i.e. supporting one specific branch of the family. This is not in accordance to the claim by the ideology of 'good governance', that independent directors and auditors represent a party that is needed in order to balance the interest of strong owners, i.e., the family, or strong managers. In our conception, they are not balancing the family, but mediating within the family.

We would also like to point out the possibility that both the incentive system and the capital structure could be designed to fit both the firm's and the family's economic situation taken together. This implies that the capital structure or incentive system at first glance may not seem proper if one only considers the firm's situation, but if considering the needs of the family as well, an interplay between the needs of the two different units would be present. This could for example be manifested in higher dividends in periods when the family needs economic support, or bonuses etc. to family members based on their personal economic needs rather than their performance in the firm.

Our analyses have shown that governance mechanisms obtain a specific form in family firms due to the family character. It could very well be the case that these specific forms at the bottom line imply lower or higher levels of financial effectiveness, as indeed have been claimed. But effectiveness is problematic when it concerns family firms since one characteristic of family firms is that financial performance could be but a mean for other, more important goals, such as survival. And the bottom line is an empirical question, which we cannot claim that we have exhausted yet.

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Figure 1. Governance strategy (Collin 2007:217)

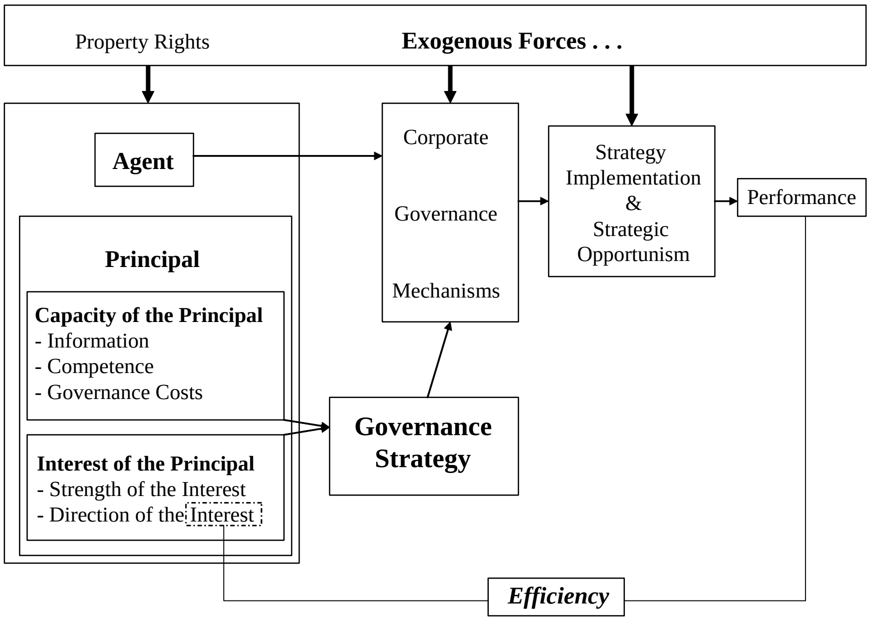

Table 1. Family firm characteristics concerning corporate governance

Premises and Intentions	Actions	Consequences
The firm is a mean for the family	Control more important than profit	Low risk for stakeholders
Non-financial goals	Long term relationships	Ambiguous border
Generational stage	Long term perspective	Strong governance strategy