The family capital and the role of the intangible assets

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"The aim of this article is to analyse the various assets of a family of entrepreneurs. We will also take into consideration the role of the family office in the interaction among these assets, paying particular attention to the intangible assets"

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The three components of a family capital

The capital of a family who wants to keep the control of its own business throughout generations can be divided into three components:

1) the family business: it is a tangible asset but it is not disposable for sale (if the family wants to transfer the business to the next generation);
2) the rest of the family's tangible assets (financial, real estate, artistic investments…): it is a tangible component available for sale as these assets are usually bought and sold;
3) the third component consists of the network of relations and reputation built over the years by the family: this is an intangible component, even though it is sometimes fostered by tangible goods (for example, philanthropic activities sponsored by the family business or by the family itself).

Let us assume that a family has made the choice to retain the control of the family business over different generations. Therefore the family business is entirely controlled by the founder's heirs (or descendants). Let us also assume that this family is composed by different branches and has accrued over the years a significant share of its own capital even beyond the family business.

Table 1 shows the interactions among the family and the three components of its capital.

In order for a company to grow and flourish over the years, all the three components of the entire capital must be managed in a balanced, effective and efficient way. We do not want to analyze the criteria of a good family business management[1], we will only touch upon some of the basic elements of a good governance of a family business: clear distinction between company and family capital, presence of independent board members[2], autonomy and responsibility of the management in line with the general policies and strategies set out by the shareholders, high level and quality of the management with the presence of external managers, formal and well defined succession process of the top management, clear cut dividend policy. However, it is obvious that the above governance criteria might limit the decision-making autonomy of the shareholders and tend to reduce the personal economic benefits for each single member of the family[3].

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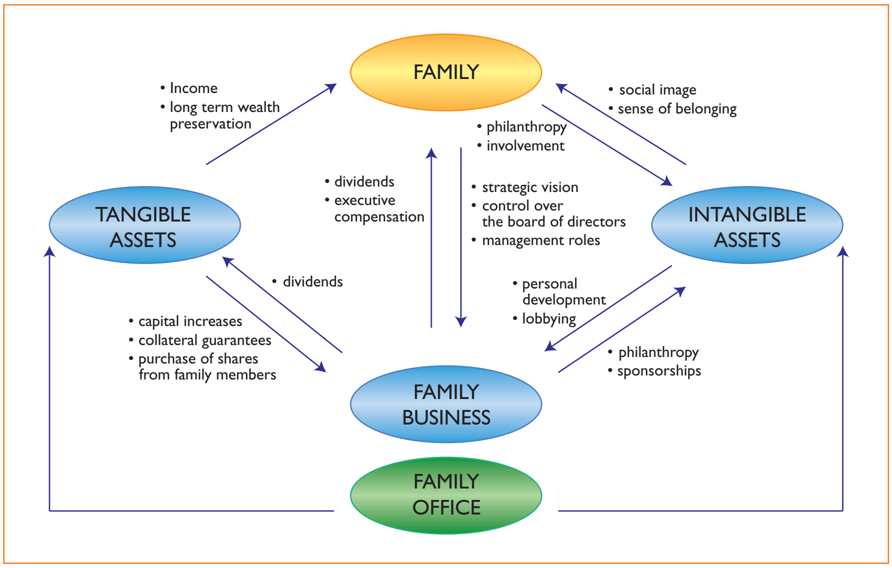
1 S. Cordero di Montezemolo, *La governance per le aziende familiari*, "Amministrazione & Finanza", March 2011, page 42.

2 P. Marchettini and G. D'Alò, *Il ruolo dei consiglieri indipendenti nelle società familiari*, "Rivista Aiaf",, number 76, September 2010, page 10; C. Bettinelli, *Boards of Directors in Family Firms: An Exploratory Study of Structure and Group Process*, "Family Business Review", 24(2), 2011, page 151.

3 P. Marchettini and G. D'Alò, *Governance delle imprese familiari e capitale intangibile*, "Journal of Investor Relations", number 2/3, September 2010, page 23.

Table 1 - The three components of a family capital



Interactions among the three components

In this context, a sound and good management of the family assets (both tangible and intangible components) should help avoiding controversies, tensions and family clashes over the management of the family business. In other words, the second and the third components of the family assets might serve as a clearing house in order to satisfy the economic and image needs of the family members who are not directly involved in the management of the family business (*i.e.* the first component).

Interactions between the first and the second components are evident. The rest of the family property (beyond strictly personal belongings, first of all the main and the secondary residences of each member) must be managed in an optimum way in order to create a constant income and to guarantee its preservation. Constant income has to balance a possible lack of dividends during periods of crisis or when major investments are necessary if the company has to grow or (worst) to survive. Furthermore, a constant income avoids that some family members, in case of lack of dividends, press to get managerial jobs even without any skill nor propension. The conservation of the capital invested outside the family business contributes to strengthen the concept that the family business is not a disposable asset. This concept is necessary to keep the control throughout generations.

Dividends allocated by the family business are another example of interaction. These dividends not only offer an advantage to family members, but they could also increase the rest of the family tangible capital which could be used as bank collateral should the family business need loans or which could be reinvested in the purchase of the shares of those family members who do not want to remain anymore shareholders in the family business.

Finally, if assets non invested in the family business are large enough to assure both a constant income and the capital conservation, there could be some resources available to finance entrepreneurial activities for those family members who do not play an active role in the family business or those who are not interested in it. Supporting such activities is very useful to develop an entrepreneurial mind among the family members belonging to the third or fourth generation (those who didn't assist to the birth of the family business) and in some cases it can also turn out to be a very good investment.

Interactions between first and third components are less obvious, but they can be very important. In fact, the position and reputation of the family built over the years play an important role in the family business. In a way, the reputation of the family and the good personal relationships of the family members, a strong brand, the links among family members, family business and brand, are an asset that contributes to the promotion of the image of the family business and to the satisfaction of the social needs of the individual members of the family not directly involved in the family business.

Sponsoring philanthropic, cultural and artistic activities contributes to the development of the intangible assets. Furthermore, the involvement of those family members who are not active in the business can contribute to their personal development with the feeling of pride of belonging to the family. On the other hand, moral and image assets can contribute to create interesting opportunities for the family business, opportunities not always easily available to multinational companies or companies controlled by private equity funds. The following sentence: "*We have been here for generations and we want to continue to stay here*" contributes to the credibility of a family business, especially in a period of globalization and delocalization.

Generally speaking, the relation between the capital made up by the family business and the intangible capital should be strengthened by a good communication of the long term company strategies to the family members who do not actively operate in the company. This way they should consider the company not only as a source of dividends, but also as a constant contribution to the development of their intangible capital.

The disclosure of the intangible assets

In today's knowledge economy it is increasingly clear that a sustainable value creation is attributable to intangible assets. These assets are identifiable and carry a specific economic value, but they remain nonetheless often invisible in the financial statements.

According to the most important international sources and conventional schemes, these assets are represented by Human, Structural and Relationship Capital[4].

1. *Human Capital* coincides with all the people working in and around an organization

4 A. Gasperini and A. Del Bello, *Il valore del capitale intellettuale. Aspetti teorici e casi aziendali di reporting*, Ipsoa editore, Milan, July 2006.

(management and employees). The skills and experience of these people are critical. Knowledge and learning begin and end with people. Employees keep everything going every day and they originate and perfect new knowledge which can create future earnings. The key with human capital is to turn smart people into a team who want to share their knowledge and institutionalize best practices so the team is not at risk when any individual walks out the door at night[5].

The key risks associated with human capital include[6]:

- vulnerability linked to management and/or staff turnover;
- misinterpretations of information and information processing;
- loss of know-how from previous experiences;
- high degree of company dependence on key-persons;
- inadequate level of competence;
- lack of cultural propensity for change.

2. *Structural Capital* includes the huge range of knowledge that stays in the organization when everyone goes home at night (as such, it is one of the answers to human capital risk of knowledge walking out the door).

Structural capital can take many forms. At one end of the spectrum there is the formally recorded, legally protected knowledge in intellectual property (IP). Then there is the knowledge included in software and formal process. Furthermore, there is all the other knowledge residing in manuals, instructions, intranets and other written resources. Finally, at the other end of the spectrum there is the shared knowledge that is manifested in work patterns and culture which are shared and understood in the organization—but not necessarily formalized[7].

The two most common areas of focus with structural capital are around IT and IP (information technology and intellectual property). Most strategies are defensive: what can we do to protect our IT and IP? However, with structural capital, the best defence is actually to be proactive. The best way to protect the ideas is to implement them consistently across the firm and to provide good training and consistent quality control. The better your execution, the harder it is to imitate your knowledge and systems.

The key risks associated with structural capital include[8]:

- inadequate documentation of business processes;
- loss of acquired/available knowledge;
- shortages in the internal control system;
- weak and/or misaligned company procedures;
- inadequate protection of intellectual property rights.

3. *Relationship Capital* is not always immediately understood as a knowledge asset. But the growing interconnections facilitated by technology with customers, outsourcing partners, suppliers, financial analysts, rat-

5 http://www.i-capitaladvisors.com, *Intangible risk series*, Mary Adams, 12 August 2011.

6 A. Gasperini, *Nuovo credito alle PMI: valutare gli asset ed i rischi intangibili*, "Journal of Investor Relations", number 4, December 2010, page 73.

7 http://www.i-capitaladvisors.com, *Intangible risk series*, Mary Adams, 15 August 2011.

8 See note 6.

ing agencies, trade associations and more in general the economic and social context of its operations, have created a body of shared knowledge that is critical to the operation of many business.
Shared is a key word here because, while sharing is an important component of relationship capital, it also represents a source of risk to the organization.
Other aspects of the relationship capital are embodied in brand and reputation. Reputation gets more and more attention because of the vulnerability created by social media and always-on communication systems. Any mistake can be broadcast immediately and the price for it can become significant. In many ways, reputation has become the most important metric for business today: it's your license to do business in the future[9].
The key risks associated with relationship capital include[10]:

- vulnerability of the client list, partnerships, and supplier chain;
- lack of customer loyalty to company;
- threats to brand value/reputational risks;
- disputes with trade unions;
- lack of support in restructuring plans.

Each entity owns and/or has access to intangible assets that fit into all of the above three categories. However, one of them may often be more significant than the others, depending on the company's business model and/or sector. Nevertheless, only their mutual relationship can represent a significant value driver to market competitiveness – a distinctive feature *vis-à-vis* other competitors – and plays a strategic role for growth: "*… a three-star restaurant is successful mainly because of the human capital embodied in its chef, a franchise such as Burger King relies on the capital structure of its recipes and proceedings, a small local restaurant is successful thanks to its relationship capital – the waitress calls you by name and knows that you like coffee no sugar with a dash of milk*"[11].

The intangible assets and the family business

The identification, evaluation and communication of the intangible assets constitute one of the most competitive successful factors in today's knowledge economy. First of all the reputation of the family and the relationships among the family branches, the single family members and the family business, the power of the brand and the connection among family business and brand, and in general all standard intangible assets (like client satisfaction, quality of the product, personal development of the employees) represent an intangible capital necessary to support the image of the family business, the expectations of the stakeholders and ultimately those of the shareholders[12].
In this perspective, the management and the communication of the intangible assets also within a family are therefore strategic elements. In fact, after some generations it be-

9 http://www.i-capitaladvisors.com Mary Adams, *Intangible risk series*, 17 August 2011.
10 See note 6.
11 T.A. Stewart, *The Wealth of Knowledge*, Ponte alle Grazie, Milan, 2002.
12 For further information please see L. Naldi, M. Nordqvist and T. Zellweger, *Intangible Resources and Performance in Family Firms: The Moderating Role of Familiness*, Frontiers of Entrepreneurship Research, 30 May 2008.

comes essential that the management effectively discloses the recent progress and above all the future potentialities of the family business to the shareholders. The financial reporting, focused on the economic results and the tangible assets, is undoubtedly necessary, but not sufficient to communicate also all the intangible values of a family business[13].

It is broadly recognized that intangible assets like reputation, relationships and brand play a strategic role in a family business because they allow, for instance, to maintain appropriate prices of products and services, to attract qualified human resources and to facilitate the access to the financial markets. At the same time they constitute strong barriers to the access from new competitors.

In this context the involvement of family members in the business activities (*strategy making*) and their effective ability to generate extra performances[14] must be evaluated. The periodic involvement in the definition of the strategy of some family members (whose positive relationship capital constitutes an important intangible asset that cannot be acquired or transferred) allow to generate high value. Nevertheless, the impact that such intangible resources has on the performances of a family business is not always easily understandable.

On the other hand, the involvement of other family members can even cause a profit erosion or, even worse, a failure of the family business. In this case relationships can be defined as a passivity (Intangible Liabilities). A lot of intangible assets from which, in a situation of business continuity, extra performances depend often lose immediately their value in a situation of extraordinary operations such as acquisition or sale of a branch of the family business (*disruptive strategy*). This happens mainly if such operations are not correlated with the initial activities of the family and they involve accordingly a change in the business culture. Disruptive strategies could be therefore interpreted also as an implicit admission of disruption of intangible assets.

In conclusion, a family business in connection with extraordinary operations can obtain meaningful benefits and financial funding depending on the reputation and political support to the strategies of several family members. However, in the same operations other intangible assets connected to the experience of other family members risk, instead, to lose their potentiality to generate value[15].

Those family members not directly involved in the family activities (often characterized by a strong risk aversion and the fear to lose the control of their own family business) are certainly looking for dividends, but they are above all concerned with the long-term sustainability of the family business and a continuity in the ownership on which their reputation depends[16]. Such sustainability is also substantially correlated to intangible assets like the strategy of the family business, its clients and its market, its human capital, the organizational structure and the ability to innovate.

Clearly the content of the communication may be different and classified in three levels. A limited information could, for instance, be addressed to every stakeholder of the family business and a wider and "*reasoned*" information through an Intellectual Capital Statement could be provided only to family members.

The main purpose of this communication should be to strengthen the connection be-

13 A. Gasperini and S. Zambon, *Le nuove frontiere del Business Reporting*", "Rivista Aiaf", number 77, December 2010.

14 The strategy definition includes decisions about the mission and vision of the family business, identification of the potential clients and evaluation of the activities affected by the competitors. In a family business, family members are usually involved in these activities thanks to their deep knowledge of the firm, to the strong commitment and the long-term vision of the core business.

15 See note 12.

16 Sometimes also extraordinary operations, which could be correlated to an increase of performances, are postponed because of emotional choices.

tween the family and its shareholders (particularly the members of the family not involved in the family business and/or active in areas very different from the core activity of the family business). The continuity of the relationship between the members of the family and the activities will also be better guaranteed by an integrated communication explaining not only the "*logic of the numbers*" of the economic and financial statement, but also the potential of those intangible assets on which the success of a family business is based[17-18].

The role of the family office[19]

It is clear that a good management of the second component of the family capital requires a specific structure. In fact, involving company structures to manage the rest of the family wealth would compromise the clear – cut division between private and company dimensions, which is one of the main elements of a good governance of a family business. Even a "*do-it-yourself management*" adopted by all the family members cannot assure the above – mentioned objectives of profitability and capital conservation.

The specific structure usually takes the form of a family office. It can be defined as the structure made up of human, physical and relational resources (personnel, office, expertise, contacts…) which has the role of managing economical activities of the family outside the business. The family office has to deal with activities linked to the third component (the intangible one), if it is not entrusted to a dedicated foundation.

Clearly, a family office manages financial investments of the family, normally performing asset allocation and giving specific mandates to specialized asset managers. The family office is often in charge of the real estate property management and sometimes it is also engaged in artistic investments. Finally, as we previously mentioned, the family office can also expand its areas of expertise to philanthropy and to the promotion of cultural initiatives. Such activities can be carried out either by a single family office or by a multifamily office (which works for different families). It is clear that the choice between a single family and a multifamily office depends on the size and the diversity of the assets, as well as the number of family members. There is a deep difference between managing some financial activities of a single family and supplying services linked to financial, real estate and artistic investments to a variety of family branches around the world. Obviously, below a certain asset size it is not advisable to create a single family office, but it makes more sense to use the services of a multifamily office.

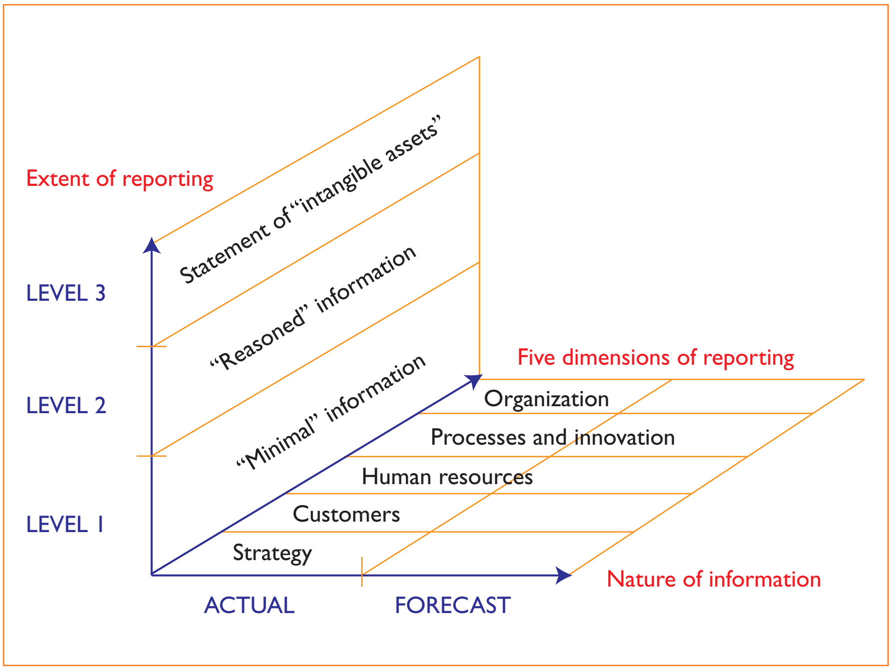
Although a multifamily office can easily manage in an effective, efficient and even customized way the assets of a large family, it can hardly guarantee a harmonious coordination amongst the three components of the family assets, a coordination vital for the prosperity and longevity of a family business.

In fact, a multifamily office has a certain number of restrictions concerning the involvement of those family members who do not play an active role in the family business. It is obvious that a single family office can offer great opportunities of involvement and professional growth to the family members. However, their involvement has to depend on criteria of competence and engagement (as well as honesty, which is a basic feature in order to avoid any misunderstanding within the family).

Single family offices and multifamily offices deal in a very different way also with the third component (moral and image assets). The link between the company, the strength of its brand, the family reputation and relations is much more effective if the philanthropic and cultural initiatives are managed by a private structure (ideally a foundation carrying the family name) and not by an external structure – a multifamily office.

To conclude, the continuity of the relationship between the family and its business throughout generations needs a careful evaluation of the governance, not only of the family business, but also of the other two components of the family assets (both tangible and intangible).

Table 2 – Communication of intangibles: the framework AIAF



Source: AIAF white paper number 106, The communication of Intangibles and the Intellectual Capital – a model of analysis, December 2001/January 2002.

17 http//www.wici-global.com, World Intellectual Capital Initiative (WICI).

18 R.G. Eccles and M.P. Kruzs, *ONE Report. Integrated Reporting for a Sustainability Strategy*, John Wiley & Sons Inc., Hoboken New Jersey, 2010.

19 P. Marchettini, *Capitale familiare e ruolo del family office nella governance del family business*, Convegno *La governance per le imprese familiari*, Milan, 6 July 2011.