# THE IMPACT OF THE NEW ITALIAN EARLY WARNING SYSTEM PROVIDED BY THE IC-CODE ON FAMILY SMES GOVERNANCE

Patrizia Riva *, Maurizio Comoli **

* *Corresponding author*, Università del Piemonte Orientale, Italy
Contact details: Dipartimento di Studi per l'Economia e l'Impresa (DiSEI), Università del Piemonte Orientale, via Perrone, 18, 28100 Novara, Italy
** Università del Piemonte Orientale, Italy

OPEN ACCESS

**How to cite this paper:** Riva, P., & Comoli, M. (2019). The impact of the new Italian Early Warning System provided by the IC-Code on family SMEsgovernance. *Corporate Ownership & Control, 16(3),* 64-72. http://doi.org/10.22495/cocv16i3art6


**ISSN Online:** 1810-3057
**ISSN Print:** 1727-9232

**Received:** 21.03.2019
**Accepted:** 06.05.2019

**JEL Classification:** G34, G32
**DOI:** 10.22495/cocv16i3art6

## Abstract

The Early Warning System is intended as an instrument aimed at driving the companies in the identification of the very first signs of crisis. Monitoring the occurring of the crisis is no longer a responsibility of the sole entrepreneur or of the board of directors but other legitimized subjects are identified. The IC-Code sets up new corporate governance rules for a huge number of Italian Family SMEs pretending the introduction of independent control bodies, Board of Statutory Auditors, and/or External Auditor. Some of the suggestions coming from the family business framework seems then to be enforced by law in the Italian context.

**Keywords:** Early Warning System, Italian Insolvency and Crisis Code, Board of Statutory Auditors (Collegio Sindacale), Auditors, Family Firms, SMEs Governance

## 1. INTRODUCTION

The Italian legislator with the Decree-Law No 155/2017, which in February 2019 has been converted into the new Insolvency and Crisis Code (IC-Code), has introduced a compulsory Early Warning System to detect occurring crisis. In its life cycle, a company may experience periods of crisis. Detecting any signals in time is very important: the company's survival may depend on it. If the crisis is monitored promptly and appropriate measures are taken, not only may the enterprise continue to operate but it may also be able to seize opportunities for growth. The concept of crisis, for entrepreneurs, is complex to deal with. Many of them show an attitude of rejection of this eventuality and have a substantial difficulty in admitting the decline, at least until it assumes such importance that the crisis can no longer be hidden. In fact, crises are generally preceded by stages of worsening of the situation which, if promptly diagnosed and dealt with, allow stopping the degenerative process and trigger a turnaround. Crises often occur not because they are inevitable, but because companies cannot catch the warning signs, so they are not able to monitor the threats to prevent them and consequently to limit the damage. This phenomena is more evident in Family SMEs which are usually family firms directed by a sole entrepreneur or a family board used to concentrate all responsibilities in her hands and in which governance structure is not considered a relevant issue (Colarossi, Giorgino, Steri, & Viviani, 2008). The IC-Code sets up new corporate governance rules for all those entities pretending the introduction of independent control bodies. The Early Warning System is intended as an instrument aimed at driving the companies in the identification of the very first signs of crisis. Monitoring the occurring of the crisis is no longer a responsibility of the sole entrepreneur or of the board of directors, but other legitimized subjects are identified. These are, on the one side, the corporate control bodies which in Italy are the Board of Statutory Auditors (*Collegio Sindacale*) and/or the External Auditors and on the other side some qualified creditors such as IRS

(*Agenzia delle Entrate*), the national insurance institution and the tax collection agent. Among these subjects it is undoubtedly the Board of Statutory Auditors to play the role of the main recipient of the signs of crisis as a body assigned to monitor and supervision to enforce compliance of management with statutes and by-laws. This is confirmed by the significant extension of the number of companies – particularly Family SMEs - that will be obliged to change their habits converting their simple entrepreneurial governance by providing for at least some kind of control bodies to cope with the new Code. Size of the company becomes then crucial: in the near future there will be a change in Italy that is expected to involve the governance a big number of companies. The appointment of the corporate supervisory body - Board of Statutory Auditors and/or External Auditor - becomes mandatory if the company has exceeded for at least two consecutive years one of the following:

- total assets in the financial statements: 2 million Euro;
- the revenues from sales and services: 2 million Euro;
- employees employed on average during the financial year: 10 employees.

The IC-Code aims at changing Family SMEs Corporate Governance: special Italian approach to the matter is chosen introducing independent professionals with a watchdog role. On one side this means that no direct impact is registered on the board structure. Independent professionals do not take part to the decision making process nor as executive, nor as non-executive directors. On the other side the novelty – for Family SMEs - is that they mandatory "seat in the room" as they are asked to participate to the board meetings. Their duty is to monitor compliance and going concern matters, having the power - when needed - first, to start the alert procedure, then, when it seems that no ways out are available, even to file for bankruptcy. The paper also considers some of the parliamentary hearings records to point out strengths and weaknesses of the legislator choices which may influence the enforcement and finally the success of the transition towards the SMEs new governance model.

## 2. LITERATURE REVIEW

The IC-Code Target SME's are 175.000 (Negri, 2017). In Italy SME's are almost all Family Firms (Gnan & Montemerlo, 2008). This means that they are firms in which the majority of the capital is held by one, or few, families connected from ties of relative, affinity or solid alliances. They represent the dominant business model all over the world (Colarossi, Giorgino, Steri, & Viviani, 2008). Family firms are known on one side for a number of strength points such as the involvement of the founder's entrepreneurial talent (Anderson & Reeb, 2003), the long-term strategic horizon (Stein, 1988; Stein, 1989, James, 1999), the access to cheaper debt (Anderson, Sattar, Mansi, & Reeb, 2003), the continuous preferential relationships both with suppliers and financial supporters (Anderson et al., 2003), the reduced agency costs due to the trust among family members (Demsetz & Lehn, 1985; Ang, Cole, & Lin, 2000), the reputation and strength in the industry going on for many generations which improve shareholders confidence and reduce potential agency conflicts (Wan Mohammad, Wan Yusoff, & Salleh, 2014). Besides on the other side several scholars attribute to Family Firms several self-defeating behaviours' such as nepotism and favouritism towards the family members (Kets de Vries, 1996; Gomez-Mejia, Nuñez-Nickel, & Gutiérrez, 2001) and suboptimal financing by outside equity, due to family's aversion to external shareholders. Some underline that most families do not pay enough attention to the governance of their businesses, and that good family firm governance should be the result of good family governance too (Lansberg, 1999). Inside family businesses, conflicts can easily arise. Such conflicts may be of several types: justice conflicts, role conflicts, work-family conflicts, identity conflicts, succession conflicts, arguments about power and control, role ambiguities, rivalries between brothers and sisters, conflicts between family members and employees caused by nepotism (Cosier & Harvey, 1998). Moreover, business decisions sometimes badly affect the family equilibrium (Harvey & Evans, 1994) by creating long-term family feuds (LaChapelle & Barnes, 1998). Thus, the creation of effective corporate governance structures could improve not only the relationships between family ownership and agents, but also the rules and hierarchies established inside the family (Whisler, 1988). Independent professionals are taken in great consideration because they usually provide firm specific knowledge and strong commitment towards the company (Sundaramurthy & Lewis, 2003). Similar suggestions come from the agency theory: in order to build a corporate governance system the board should be mainly composed of non-executive directors, not to undermine its objectivity (Goodstein, Gautam, & Boeker, 1994). Studies that have shown that in family firms, the classic owner-manager conflict does not occur. However, this result may be explained by the role of the board in family firms as an agency cost control mechanism that acts as a substitute for other systems. In family firms, agency conflicts may occur, but with distinctive features that enable governance systems to overcome them (Songini & Gnan, 2015). It is relevant for our work to highlight that corporate governance variations over time may help a family firm to move through its organizational life cycle, by creating an appropriate fit with the evolving strategic needs. Appropriate governance practices may contribute to strategic renewal and value creation in family business especially when moving from state of crisis to a renewed growth and profitability stage. Creating an effective system of corporate governance is a crucial task, requiring an appropriate balance between accountability and entrepreneurial dimensions to carry out the firms strategies (Di Toma, 2012). Finally Scholars assert that corporate governance is influenced by institutional factors and that the legal environment defines property rights and sets boundaries within which the companies must operate (Shleifer & Vishny, 1997).

## 3. THE NEW ITALIAN EARLY WARNING SYSTEM PROVIDED BY THE IC-CODE

Based on the indications of the Proposal for a European Directive (COM (2016) 723) – on the theme of preventive restructuring and insolvency – Italy has adopted the Directive by introducing the "Crisis and Insolvency Code" (IC-Code). In the following sections it is sought to provide a systemic reading that takes account of the indications of the new Italian "Crisis and Insolvency Code" published as a draft in December 2017 and definitively approved with amendments in February 2019. The declared objective of the new legislative set-up is to reach better creditors satisfaction by safeguarding the debtor's rights as well as to favour overcoming the crisis by ensuring a going concern. It is worthwhile emphasising that the new "Crisis and Insolvency Code" provides significant legal definition of the two "crisis" and "insolvency" concepts. Specifically, "crisis" must mean a situation of economic and financial difficulty that makes insolvency of the debtor probable and, for the companies, manifests itself as an inadequacy of the future cash flows so as to be able to regularly comply with the previous obligations. Contrarily, a debtor is defined as "insolvent" when it is unable to regularly comply with its obligations. Insolvency laws have developed more or less reliable and exact indicators for the beginning of the common pool problem such as 'acts of bankruptcy' (flight of the debtor, non-payment of an adjudicated claim, etc.) or general definitions (over-indebtedness, illiquidity, etc.). In more recent years, the reach of insolvency (and hybrid) proceedings has, in many countries, widened and their boundaries have blurred. Insolvency proceedings can be triggered even during earlier, often less clearly defined stages of the debtor's crisis (e.g. imminent insolvency, likelihood of insolvency, unsurmountable difficulties and similar). In some important instances, proceedings that are considered to address insolvency may even be started by the debtor without having to prove or even just assert their insolvency or crisis (Stanghellini, Mokal, Paulus, & Tirado, 2018).

### 3.1. The role of the corporate supervisory bodies

Mainly corporate crises are not sudden events. They develop an incubation phase that can be considered as physiological as it involves any company structurally. It manifests itself with the recognition of management or production inefficiencies. Its seriousness and evolution must be evaluated by the directors, including with the aid of forecasting instruments such as budget and business plan, to evaluate the evolution of the operations and intervene with specific corrections. The Board of Statutory Auditors check the conduct of the administrative bodies ensuring that an adequate administrative and organisational system is implemented with particular reference to the presence, structure and functioning, on the one side not only of an adequate accounting framework but also of an internal control system that monitors the robustness of the accounting data, and, on the other side, of an adequate management system which is able to construct reliable and effective indicators to monitor, amongst other things, the parameters identified in the new "Crisis and Insolvency Code". The new Italian legislative set up provides that when "well-founded evidence" of the crisis is recognised the corporate supervisory bodies must "immediately inform" the Board of Directors for appropriate provisions to be taken.

If the situation described is not resolved and therefore persists, the company can slide into a second phase of the so-called maturation of the crisis. Inefficiencies that are not promptly resolved in the incubation phase produce larger effects that commence undermining the corporate resources. For the purpose of having a timelier alert and, in consideration, especially in the Italian context, of the significance of the banks as the main company financiers or, in case of smaller business entities, the only company financiers, the new legislative set up has introduced some direct disclosure obligations between these parties and the corporate control bodies. More specifically the banks, at the time when they communicate changes or revisions of credit lines to the customer, must also notify the corporate control bodies, if existing. The corporate control bodies, specifically, as will be better seen below, the Board of Statutory Auditors, which constantly monitor a series of company performance indicators, are called upon in this phase to evaluate whether to put an "*internal alert*" system into place. It must be ensured that the directors are aware of the existence of a more identified and significant criticality as compared to the previous phase and of the need to enter into a well identified path to avoid consolidation of a crisis situation. For this purpose the Board of Statutory Auditors and external Auditors can decide on some further moves, this time more formal. Once the situation is classified as significant and, naturally, in the event of inertia of the directors or rather only in the case where they have not put in place adequate provisions even following less invasive interactions with these control bodies, they can indeed decide to implement a specific "notification procedure". For this purpose the Board of Statutory Auditors and the external Auditors must send a specific official written notification to the directors, motivating their decision, presumably by means of certified e-mail or registered letter with acknowledgement of receipt with which a suitable, but short term, must be fixed, which the law identifies as not more than thirty days within which the Board of Directors must refer regarding the solutions identified and the actions undertaken.

If the intervention described is not timely or does not produce a positive result, the company can however enter into a proclaimed crisis phase. The latter is characterised by the occurrence of more significant financial imbalances that, once again, if not actively managed, can seriously undermine the going concern. A "crisis" is arrived in a legal sense or rather, as anticipated, as the "inadequacy of the prospective cash flows to regularly meet planned obligations". The corporate supervisory bodies check the correct approach to an interlocution process with strategically significant parties for company survival. They must also evaluate whether the company can still autonomously exit from the crisis under only the guidance of the directors or else if, for the purpose of making the company's business secure, it is necessary to commence a process of

*"internal alert to the outside"*. In this connection the new legislative set-up provides that, in the case where the programmed interventions, including possibly following an "internal alert", first informal and then formal, as mentioned in previous phases, these are considered as inadequate or in the case of inertia, meaning failure to adopt sufficient measures, the corporate supervisory board must inform the specific third party entity called the OCRI (*Organismo di Composizione della Crisi di Impresa*) or "Company Crisis Composition Committee" of the situation recognised. It is necessary to show that:

- on the one side, the timely notification to the company crisis composition organism constitutes a case of exoneration from joint and several liability for the corporate supervisory bodies for prejudicial consequences of the omissions or actions subsequently conducted by the Board of Directors, differing from the directives received, which are not direct consequences of decisions adopted before notification;
- on the other side and in the same way, reward measures and measures holding the entrepreneur harmless against any punishable liabilities, if the same provides a timely remedy for the crisis situation occurred.

### 3.2. The role of the qualified public creditors

Furthermore, the new code identifies a specific category of parties considered as particularly significant for the purpose of the timely emersion from the crisis that are defined as "qualified public creditors" and to which very significant powers are attributed in relation to the alert process. This refers to the Revenue Agency, national institute for social security and agent for tax collection. The power to start a further notification to the "Company Crisis Composition Committee" is attributed thereto. This refers to a "*totally external alert*" or, rather an "*external alert to the outside*" as it is promoted by a third party with "contrasting interests" to the company reality and directed to another external party. The procedure provided for is made totally objective as it operates in accordance with specific automatism in relation to the overcoming of debts watch-list thresholds, it is necessary to understand that accordingly it could have already been activated even in prior phases. This refers to a method of inserting a totally autonomous and simultaneous alert compared to that entrusted to the corporate supervisory bodies. Indeed no coordination between the two processes seems to be envisaged, nor is it explicitly required that there is a direct and preliminary exchange of information between the two parties.

### 3.3. Intervention of the OCRI, (Company Crisis Composition Committee)

The effects of the activation of the OCRI are immediate. The Committee is in fact expected to appoint a board of three independent professionals (hereinafter also Triade), required to comply, among other things, with the obligation of confidentiality regarding all information acquired in the exercise of its functions and to the secrecy regarding facts and documents of which they become aware by reason of the office. The Triade promptly convenes the directors to identify together the possible measures to be undertaken to remedy the crisis and fix a period within which the directors must report in order to implement them. If the company proves to have identified a specific path and to have undertaken useful steps to follow it through, a time frame is set of not greater than three months, extendable to a maximum of six months in case of positive results of the negotiations, for the search for an agreed solution to the crisis. In most cases the path proposed by the company must be extra-judicial in nature and executed with written agreement with the creditors that are deposited with the Committee and are not conspicuous to different subjects than those who subscribed to them. These agreements assume a relevant legal value in that they are not liable to revocation action as they would have been in the case of implementation of a certified plan. The new Code does not exclude direct recourse to crisis regulation procedures without a preventive attempt at extrajudicial agreement.

In case of failure of the extra-judicial negotiations, assisted or not by the Triade appointed by the OCRI, the phase that legal theory characterises as reversible insolvency is entered into. The new code, as already mentioned, characterises "insolvency" as the state of the debtor no longer in a position to regularly satisfy their own obligations. In this phase this situation is noted and manifests both in a company context and externally against third parties for the failures and for the failed attempts to meet free individual or collective agreements with creditors. In the event that the external alert has already been activated in the previous phase and, at the expiry of the assigned or extended deadline, it has not been possible to reach an extra-judicial agreement with the creditors involved, the Triade invites the debtor to apply for access to a crisis regulation or insolvency procedure within a very short time frame (maximum of 30 days). To counteract the difficulties of the crisis, the legislator has introduced in the last decade some specific instruments: a) the attested plan (ex. Article 67 of the Bankruptcy Act, become Article 60 of the IC-Code); b) the restructuring agreement (ex. Article 182 bis of the Bankruptcy Act, become Article 61 of the IC-Code); c) the preventive agreement (ex. Article 160 of the Bankruptcy Act, become Article 89 of the IC-Code).

If the directors do not see the possibility of taking recourse to one of the crisis and insolvency regulation procedures or the latter have not led to the hoped for outcome, the company is considered to be in the final phase of the process referred to as confirmed insolvency. The situation is now irreversible, remedial objectives are no longer usefully achievable, nor are there sufficient fresh financial means available to implement an agreed settlement.

## 4. THE WIDENING OF THE RANGE OF CORPORATE BODIES SUBJECT TO LEGAL FORMS OF CONTROL AS A CONDITION FOR THE SUCCESS OF THE ALERT PROCESS

According to recent researches, Limited Liability Companies with mandatory Board of Auditors were less than 3% of the total in 2013 and the great majority of them entrusted the accounting auditing

to the same Board of Auditors, continuing the deeply rooted Italian tradition (Bellavite Pellegrini, 2013). So the scope of the IC-Code asks for a big change as it asks the enhancement of company supervisory function broadening the range of corporate bodies subject to legal forms of control. The appointment of the corporate control body (Board of Statutory Auditors or sole statutory auditor), or of the auditor becomes mandatory for all companies if the size is relevant no matter the form of society. This happens if the company has exceeded, for two consecutive years at least one of the following three limits:

- total assets on balance sheet: 2 million euro (equal to less than 50% of the previous limit of 4.4 million euro);
- revenues from sales and performance: 2 million euro (equal to less than 25% of the previous limit of 8.8 million euro);
- employees employed on average during the year: 10 units (equal to 20% of the previous limit of 50 units). The obligation to appoint ceases when, for three consecutive years, the aforementioned limits are not exceeded.

This cultural transition shall probably be much greater and more invasive than the introduction of the OCRI as well as the identification of automatic crisis detection mechanisms imposed on qualified public creditors. The introduction of these new thresholds represents a clear recognition of the usefulness of the control functions carried out according to the deontological and professional standards of reference for the correct functioning of the corporate system. It is a choice that is designed to change the behaviour of directors of medium businesses, but above all of small and micro businesses that, as noted, are very numerous in the Italian environment and that to date have escaped the obligation to equip themselves with adequate internal control systems, if not even with adequate accounting and management systems.

## 5. SUPERVISORY ACTIVITIES AND THEREFORE THE "EX ANTE" CONTROL CARRIED OUT BY THE BOARD OF STATUTORY AUDITORS

With the issuing of the "Commercial code" in 1882, a supervisory body was introduced in Italy in order to verify compliance with the law, the Constitution and by-laws so as to entrust the company's fate not entirely to the directors, placing their activities under the control of independent professional parties so as to protect the interests of the company, its shareholders and of all stakeholders. In fact, the protection of all interests must be emphasised among the functions of the Board of Statutory Auditors. It is a unique model on the international scene as it envisages a specific body composed exclusively of professionals, completely independent from the board of directors, which are in charge of the *ex ante* control of the latter's activity. The Board of Statutory Auditors is typical of the so-called "traditional" management system that represents the prevailing model in the Italian context. The structure of the traditional model provides for:

- the administrative body appointed by the shareholders' meeting that is responsible for managing the company;
- the Board of Statutory Auditors also appointed by the shareholders' meeting which supervises the work of directors;
- the auditor, always appointed by the shareholders' meeting, who is responsible for the control of the accounting management. In small companies the Board of Statutory Auditors can easily fill both roles. Alternatively to this model, Italian companies can access the so-called "one-tier system", a system consistent with the Anglo-Saxon governance models, and the "two-tier system", consistent with the German model, which are also widespread internationally.

It is important to underline that the traditional model allows for a precise division of roles: the administrative function is clearly separated from the supervisory and control functions. The Board of Statutory Auditors is composed of three or five standing members plus two alternate members and at least one of the statutory auditors and one of the alternate members must be a registered auditor. From the introduction of corporate reform (Italian Decree-Law 6/2003) the Board of Statutory Auditors is responsible for supervising this term by entering into:

- compliance of the law and the by-laws;
- verification of compliance of directors' decisions with principles of rationality, assessing whether the necessary information has been taken into account;
- the adequacy of the organisational structure in relation to the size, the nature of operations and strategies planned for achieving the company goals.

To fully exercise their duties, the members of the Board of Statutory Auditors participate in the board of directors directly assisting the decision-making processes and, if necessary, intervening by exercising their control powers when decisions are about to be taken (*ex-ante* control). This also assumes a decisive importance, inter alia, for purposes of alert, as will be shown below, as any external control body, and above all, the auditor can only intervene when strategies have already been deliberated on and implemented to record the effects of these on the company balance (*ex-post* control). The peculiarity of the Italian control system is the coexistence of two levels of control. A downstream control performed by the auditors responsible for the accounting management and an upstream check by the Board of Statutory Auditors on the behaviour of directors. The Rules of Conduct of the Italian National Council of Chartered Accountants and Accounting Experts for the Board of Statutory Auditors, establish that the latter in the performance of the function recognised by the law, ensures that the control system on the one side and the organisational and administrative arrangements on the other - and therefore the accounting and management systems - adopted by the company are adequate to promptly detect signals that raise significant doubts about the company's ability to continue operating as an operating entity. The document states that the Board of Statutory Auditors can request clarifications from the administrative body and request the latter to take appropriate measures.

It is only necessary to remember that the board's supervisory role has been attentive and

praised also by foreign observers. Joseph Stigliz[2] - Nobel Prize winner for economy in 2001 - highlighted the critical issues and risks of the governance systems based only on external controls, or in other words with only external Auditors *ex post* controls, in the absence of a careful *ex ante* supervision activity - typically the Anglo-Saxon models - praising the Italian model based on a structure that presents an independent and internal control body, namely the Board of Statutory Auditors whose role has been emphasised by the new code.

## 6. SYSTEMIC INCONSISTENCY OF THE NEW PROVISIONS IF ONLY THE EXTERNAL AUDITOR IS APPOINTED. A MISSED OPPORTUNITY FOR REFORM

An important consideration must put forward. We have already said that the legislator has intervened heavily on Art. 2477 of the Italian Civil Code which provides for the cases in which it is compulsory to appoint a control bodies, considerably increasing the number of companies involved. However, it is envisaged that it is possible to alternatively appoint the Board of Statutory Auditors or an External Auditor.

The final text presents important systemic inconsistencies that risk jeopardising the effectiveness of the use of indicators for crisis prevention allowing companies to choose which type of control to undergo. All companies, in fact, can decide whether or not to have a corporate control body - which is the Board of Statutory Auditors - or to limit themselves to appointing only the External Auditor who, as already highlighted in the previous paragraph, has no supervisory powers.

It has already been considered that the crisis is defined by the new point or section of the law as the inadequacy of future cash flows to regularly meet planned obligations. The Crisis and Insolvency Code therefore requires that a corporate control body focus its attention on the company's future prospects and to this purpose it is necessary for it to exercise supervisory powers over the actions of its directors. The analysis of results obtained in the past cannot be considered sufficient to assess whether the company is entering a crisis period or not, at least not in the sense introduced by the act. In fact, the External Auditor performs an *ex post* control and its audits inspect the annual financial statements. On the basis of these activities, the External Auditor will certainly be able to provide for the alert, but his intervention can only be structurally late and therefore inconsistent with the time-scales established by law for carrying out checks for purposes of alert and consequently with the need for timeliness expressed by the Code.

The legislator's choice on whether or not to appoint the Board of Statutory Auditors mandatory in any case, structurally weakens the crisis prevention mechanism and is a consequence of the erroneous conviction of the existence of an interchangeability and overlap between the two figures. On the contrary, within corporate governance studies and practice it is well known that the two roles are very different. It is only necessary to recall that the External Auditor's functions are limited to expressing a professional opinion on the correctness of the statements, and are codified by the auditing standards published in the European Union's official journal. They are in no way comparable to the supervisory functions assigned by the Italian Civil Code to the corporate control bodies (see Articles 2400 et seq. for statutory auditors). In particular, the External Auditor: does not participate in the boards of directors and does not oversee either management or the appropriate arrangements. Furthermore, it is only necessary to remember that it cannot express opinions on interim accounting situations (see doc. Assirevi 173). It would therefore be desirable, as suggested in more than one parliamentary hearing, to provide for the appointment of either the Board of Statutory Auditors or External Auditor. In particular, it is worth mentioning that many Institutions expressed to be in favour of the change during the work in the Senate Judiciary Committee. Among others we mention the Working Group Rordorf 2 of the Italian National Council of Chartered Accountants and Accounting Experts (CNDCEC), or the Association of Professionals for Corporate Restructuring (APRI) and some academics including representatives of the University of Eastern Piedmont and the University of Bergamo with its Insolvency Observatory. As is clear from the records of the hearings to the Senate Judiciary Commission of November 2018, it was suggested to amend Art. 378 - Appointment of control bodies - Paragraph 1 - modifying Art. 2477 of the Italian Civil Code, the third and fourth paragraphs as follows: “The appointment of the control body and of the external auditor is mandatory if the company: ... (omitted).” It has been argued that the mere modification of the conjunction "or" in the conjunction "and" (both in the first and last section of the first paragraph of amended Article 2477 of the Italian Civil Code) would greatly strengthen the control mechanism on limited liability companies, which is instrumental to crisis prevention.

Further reflection is important. Contrary to what was sometimes suggested, the desired further legislative action would not have led to an increase in costs for small and medium-sized enterprises. It would not have been necessary in fact to appoint two separate parties as current law already states that the Board of Statutory Auditor can also perform the functions of the External Auditors. On the contrary, current law does not state the opposite, i.e., it does not state that External Auditors may carry out the supervisory activities: in the latter case, in fact, the status of “Board of Statutory Auditor” needs to be attributed necessarily to them. Hence having the “Board of Statutory Auditors” which in small entities can be monocratic with a sitting alone Statutory Auditor, only one person could be appointed but all the necessary powers for the pursuit of the alert's purpose would have been acknowledged. In summary, by incorporating the suggested amendment, a single controller would be introduced into corporate *governance*, as evidenced by the legislator in the case of SMEs, but the latter would have been equipped with both accounting management and essential supervisory powers, so on the one side, in small companies the appropriate arrangements were introduced and on the other side

[2]Stiglitz J. "The Anglo-Saxon corporate governance system has failed. Now look at the Italian model". CNDCEC, Press Release, 2009.

the latter were more ready to face the introduction of alert mechanisms into the legal system.

We cannot fail to notice that, if the non-amendment of the law were linked - as it is - to the need for cost containment in small and medium-sized companies, the rule implies that by appointing the External Auditor the latter shall, or rather, must take on new responsibilities in terms of providing alerts services for free. However, this seems hard to apply and therefore the appointment of only the External Auditor - instead of sitting alone Statutory Auditor - shall not in fact lead to cost savings for companies. The strength of the above motivation, if it were - as it seems - at the basis of legislator's choice, seems therefore rather diluted.

In short, the Code in its definitive formulation merely does nothing other than request the External Auditors inappropriately, as it does not acknowledge the necessary powers, to perform tasks that do not fall within its remits. A *de facto* mutation of the very nature of the External Auditor's role is claimed by law as paradoxically the latter is requested to "*be a sitting alone Statutory Auditor*".

In light of the reflections, it seems more than appropriate, regardless of the social form, to return to impose the presence of the Board of Statutory Auditors or at least the sitting alone Statutory Auditor delegating to the latter also the audit or providing that the latter work alongside the External Auditor. This is especially desirable in the larger companies with a board of directors - such as those that exceed the scope of Art. 2435-bis of the Italian Civil Code - even if organised in the form of a limited liability company (SRL) and not of public limited company (SPA). The above provision has been confirmed in the first comments to the wording of the new code.

## 7. THE INDIRECT "INTRODUCTION BY LAW" IN SMES OF ADEQUATE ADMINISTRATIVE, ORGANISATIONAL AND ACCOUNTING STRUCTURES

In the Italian context, it is often noted that in small family companies administrative functions are still perceived as an unavoidable but "useless" cost as an obligation linked to the need to comply with mainly fiscal obligations. Often activities are delegated in total outsourcing without taking advantage of the opportunity to request in addition to mandatory obligations also useful tools for guiding the management and administration. The potential scope of the accounting tool and the relevance of the implementation of management control systems are not included. This way, the drafting of even basic instruments such as the simple company periodic reports or business units reports and, consequently, the identification and computation of significant KPI necessary for a good governance are far from being widespread. Planning and activities of drawing up economic, financial and asset budgets are almost absent. Besides in the rare cases in which they are implemented, they are often managed in a non-professional way in the absence of any explanation of the assumptions or without strict consistency among the statements drawn up.

It is worth pointing out that in these situations management control systems mentioned here, when present, are considered to be enough for all purposes. This means that they are often confused with the different structures linked to control and supervision activities. This means that they are mistaken for the Internal Control System (ICS). The latter, as known, responds to various needs and refers to different models and objectives, consisting of the processes implemented by the board of directors, executives and other parties of the company structure:

- to provide a reasonable assurance in terms of reliability of the information contained in financial statements;
- to achieve compliance objectives of organisational behaviour or compliance with the laws and regulations in force;
- and finally to achieve a greater awareness of business risks and to allow continuity in achieving the objectives of effectiveness and efficiency of operating activities.

The Internal Control System, as it should be mentioned in this context, is in fact represented by the lines of action and procedures - or internal controls - adopted by the management in order to allow for the achievement of corporate goals and to ensure an efficient and orderly conduct of corporate activities. However, the management of the company risk profile presupposes the knowledge and therefore the careful study of the nature of the various types of risks that threaten the continuity of the company's activity, as well as the probability of the emergence of these risks and their expected impact so as to provide for strategies for managing the various types of risks. Recent decades have made it possible the development and dissemination in the international field of theoretical models related to the Internal Control System that provide for conceptual references to the components of the latter in an manner which is easy to understand and share, as well as definitions of general applicability that ignore sectorial and geographical boundaries. Particularly worth mentioning here are the *COSO Report* and *Enterprise Risk Management* frameworks developed by the *Committee of Sponsoring Organizations*. The *COSO Report*, which is the results of the study carried out by the *Committee of Sponsoring Organizations of the Treadway Commission* (COSO) in 1992 and which was revised in 2013, represents a reference model aimed at improving internal control systems and providing the various components of the corporate structure with a common concept of control. The *Enterprise Risk Management (ERM) Framework* instead - published in 2004 by the same *Committee of Sponsoring Organizations of the Treadway Commission (COSO)*[3], represents a reference model that companies can adopt for managing business risks aimed at analysing the factors of risk, the assessment of their impact on company performance as well as the creation of value and competitive advantage. In other words, the ERM allows the management to deal more effectively with the uncertainties and consequent risks/opportunities, increasing the company's ability to generate value (or at least not to disperse it) achieving a balance between growth and profitability goals and the consequent risks. Business risk management is a process carried out by the Board of Directors, executives and other operators of the

[3]Please see https://www.coso.org/Documents/COSO-ERM-Executive-Summary-Italian.

company structure, used for creating strategies throughout the company, designed to identify potential events that may affect the company's activities. The company must establish its own "acceptable risk" by identifying significant risk indicators (KPIs) and thus setting limits that allow for a reasonable assurance in terms of the achievement of company goals. The ERM is therefore a continuous process that involves the entire company and takes the form of a sequence of activities that must be pervasive and integrated within the existing management system, in order to avoid the addition of parallel procedures that would entail further costs and it is carried out by people who occupy positions at all levels of the company organisational structure that influence the effectiveness of the process and which in turn are conditioned by it.

## 8. CONCLUSIONS, LIMITS AND FUTURE RESEARCHES

In this paper, we have investigated how the corporate governance of Italian Family SMEs is expected to change in the near future.

•We have pointed out that the new IC-Code can be considered to implement in a special Italian way some of the main suggestions coming from the family business framework (among the others already cited supra: Whisler, 1988; Goodstein, Gautam, & Boeker, 1994; Shleifer & Vishny, 1997; Sundaramurthy & Lewis, 2003; Colarossi et al., 2008; Di Toma, 2012). What is being implemented in the Italian context confirm that an appropriate governance practices may contribute to strategic renewal and value creation in family business especially when moving from state of crisis to a renewed growth and profitability stage. The involvement of independent professionals in the governance is considered so precious by the Italian legislator that they are heighten to the role of going concern and compliance guardians even in small sized family companies. Legal environment defines sets boundaries within which the companies operate and, as it often happens in Italy, changes are driven by the Legislator choices. Family SMEs are expected to shape in a few months their behaviours to fit the new requests, but this will take only to formal compliance. More time will be reasonably needed to have the novelty understood and internalized and finally to get the result to deeply change behaviours.

•We have underlined a strong point of the IC-Code which is the fact that the provision of control bodies implies the need to strengthen administrative organization. It enforces the enhancement - or the introduction *ex novo,* when necessary - of accounting, management and control processes and structures. On the one side articulated accounting and management systems will be essential to create dashboards of indicators deemed useful to manage and prevent crisis situations and therefore trigger alert procedures introduced by the Code. On the other side structured internal control systems will be needed to assure data robustness. Transparency is expected to improve as structural mix up between company and family affairs should start being faced and discussed.

•We have anyway highlighted a weak point of the IC-Code which is the fact that the final text presents an important systemic inconsistencies that risk jeopardising the effectiveness of the use of indicators for crisis prevention allowing companies to choose which type of control to undergo. All companies, in fact, can decide whether to have a corporate control body - which is the Board of Statutory Auditors - or to limit themselves to appointing only the External Auditor who has no supervisory powers. The amendments required by relevant Institution - such as CNDCEC, APRI and Academia – weren't taken in consideration by the Italian Government. It will be than relevant to investigate which will be companies' future choices and the consequences on the alert process efficacy.

•We have here chosen a review approach as the IC-Code has been approved and published the 14th February 2019, but it will be enforced only from August 2020. It is important to underline that Italy has shaped the new Law being inspired by the Proposal for a Directive on Restructuring COM (2016) 723, before its final approval. The consequence is that the Italian Text can be considered a trial field itself. In particular we focus on the IC-Code provisions on Family SMEs governance which go far beyond the one asked by the Directive Proposal. Our work then aims to be a first and early discussion of the special Italian Legislation choices. In the near future other EU Countries may look at Italian experience to make their own decisions.

We are convinced that the Italian legislator choice to include Family SMEs in such a process is unique in the international panorama and will create an interesting lab for future empirical research. It will be important in new projects to investigate and measure how the introduction of the new control bodies will affect Family SMEs governance. It will be relevant to try to understand if the new rules will be considered and faced only as formal matter or if and how behaviours will be influenced and improved routines will put down roots. These new researches will need to collect series of data in more than the first application year, which is expected to be 2020 as the upgrades required are so demanding that we can expect that it will take some times for operators to understand the IC-Code mechanisms and their implications. It will be also interesting to compare the national results at an EU level when the Directive will be enforced.

## REFERENCES


1. Altman, E. I., Danovi, A., & Falini, A. (2013). Z-score models' application to Italian companies subject to extraordinary administration. *Journal of Italian Banking Association, 4,* 24-37.
2. Anderson, R. C., & Reeb, D. M. (2003). Founding family ownership and firm performance: Evidence from the SandP500. *The Journal of Finance, 58(3),* 1301-1328. https://doi.org/10.1111/1540-6261.00567
3. Anderson, R., Sattar, A., Mansi, E., & Reeb, D. M. (2003). Founding family ownership and the agency cost of debt. *Journal of Financial Economics, 68(2),* 263-285. https://doi.org/10.1016/S0304-405X(03)00067-9

4. Ang, J., Cole, R., & Lin, J. (2000). Agency costs and ownership structure. *The Journal of Finance*, *55(1),* 81-106. https://doi.org/10.1111/0022-1082.00201
5. Colarossi, F., Giorgino, M., Steri, R., & Viviani, D. (2008). A corporate governance study on Italian family firms. *Corporate Ownership & Control, 5(4),* 93-103. http://doi.org/10.22495/cocv5i4p8
6. Cosier, R. A., & Harvey, M. (1998). The hidden strength in family business: Functional conflict. *Family Business Review, 11(1),* 75-79. https://doi.org/10.1111/j.1741-6248.1998.00075.x
7. Danovi, A., Riva, P., & Azzola, M. (2017). Avoiding bankruptcy in Italy: Preventive arrangement with creditors. In S. Grima, F. Bezzina, I. Ramãnova, & R. Rupeika-Apoga (Ed.), *Contemporary Issues in Finance: Current Challenges from Across Europe* (pp. 77-94). Retrieved from: https://www.emeraldinsight.com/doi/abs/10.1108/S1569-375920160000098006
8. Danovi, A., Riva, P., & Azzola, M. (2016). PAC (Preventive Arrangement with Creditors): A tool to safeguard the enterprise value. *International journal of business research, 16(2)*, 117-134. https://doi.org/10.18374/IJBR-16-2.9
9. Di Toma, P. (2012). Strategic dynamics and corporate governance effectiveness in a family firm. *Corporate Ownership & Control, 10(1),* 34-43. https://doi.org/10.22495/cocv10i1art3
10. Garrido, J. M. (2011). *Out-of-court debt restructuring.* Retrieved from: http://siteresources.worldbank.org/INTLAWJUSTICE/Resources/OutOfCourtDebtRestructuringBeforeTypesetting.pdf
11. Gnan, L., Montemerlo, D. (2008). *Le PMI familiari in Italia tra tradizione e novità. I risultati di una ricerca.* Milan, EGEA.
12. Gomez-Mejia, L., Nuñez-Nickel, M., & Gutiérrez, I. (2002). The role of family ties in agency contracts. *Academy of Management Journal*, *44(1)*, 81-95. https://doi.org/10.2307/3069338
13. Goodstein, J., Gautam, K., & Boeker, W. (1994). The effects of board size and diversity on strategic change. *Strategic Management Journal, 15(3),* 241-250. https://doi.org/10.1002/smj.4250150305
14. Harvey, M., & Evans, R. E. (1994). Family business and multiple levels of conflict. *Family Business Review*, *7(4),* 331-348. https://doi.org/10.1111/j.1741-6248.1994.00331.x
15. James, H. (1999) Owner as manager, extended horizons and the family firm. *International Journal of the Economics Business*, *6(1),* 41-55. https://doi.org/10.1080/13571519984304
16. Jensen, M. C., & Meckling, E. W. (1976). Theory of the firm: Managerial behaviour, agency costs and capital structure. *Journal of Financial Economics, 3(4),* 305-360. https://doi.org/10.1016/0304-405X(76)90026-X
17. Kets de Vries, M. (1996). *Family Business: Human dilemmas in the family firm.* International Thompson Business Press, London, UK.
18. Lansberg, I. (1999). *Succeeding generations: Realizing the dream of families in business.* Harvard Business School Press, Boston, MA.
19. La Chapelle, K., Barnes, L. (1998). The trust catalyst in family-owned businesses. *Family Business Review*, *11(1),* 1-17. https://doi.org/10.1111/j.1741-6248.1998.00001.x
20. Negri, G. (2017). *Mandatory auditor for 175.000 Srl.* Sole24Ore.
21. Riva, P., Danovi, A., Comoli, M., & Garelli, A. (2018). *Corporate governance in downturn times: Detection and Alert – The new Italian insolvency and crisis code.* Retrieved from: https://www.intechopen.com/books/crisis-management-theory-and-practice/corporate-governance-in-downturn-times-detection-and-alert-the-new-italian-insolvency-and-crisis-cod https://doi.org/10.5772/intechopen.74964
22. Riva, P., & Provasi, R. (2013). Crisis and controls: The Italian model. *Corporate Ownership & Control, 11(1-4),* 423-434. https://doi.org/10.22495/cocv11i1c4art6
23. Riva, P., & Provasi, R. (2014). An overview Italian companies and the financial and economic crisis: A cultural revolution. *International Journal of Economics and Business Research, 7(4),* 502-515. https://doi.org/10.1504/IJEBR.2014.062932
24. Riva, P., & Provasi, R. (2016). The ability of the turnaround index to assess going concern assumptions: evidence from its application to Italian listed companies. *Global Business and Economics Review, 18(1),* 54-81. https://doi.org/10.1504/GBER.2016.073309
25. Sundaramurthy, C., & Lewis, M. (2003). Control and collaboration: Paradoxes of governance. *The Academy of Management Review, 28(3),* 397-415. https://doi.org/10.5465/amr.2003.10196737
26. Shleifer, A., & Vishny, R. (1997). A survey of corporate governance. *The Journal of Finance, 52(2),* 737-783. https://doi.org/10.1111/j.1540-6261.1997.tb04820.x
27. Songini, L., & Gnan, L. (2015). Family involvement and agency cost control mechanisms in family small and medium-sized enterprises. *Journal of Small Business Management, 53(3),* 748-779. https://doi.org/10.1111/jsbm.12085
28. Stanghellini, L., Mokal, R., Paulus, C. G., & Tirado, I. (2018). Best practice in European Restructuring. Contractualised distress resolution in the shadow of the law. Wolters Kluwer: Cedam. https://doi.org/10.2139/ssrn.3271790
29. Stein, J. C. (1988). Takeover threats and managerial myopia. *Journal of Political Economy, 96(1),* 61-80. https://doi.org/10.1086/261524
30. Stein, J. C. (1989). Efficient capital markets, inefficient firms: A model of Myopic corporate behavior. *The Quarterly Journal of Economics, 104(4),* 665-669. https://doi.org/10.2307/2937861
31. Stiglitz, J. (2009). Il sistema di governance societaria anglosassone ha fallito. Ora guardate al modello Italiano. CNDCEC, Comunicato stampa.
32. United Nations Commission on International Trade Law (UNCITRAL). (2005). *Legislative guide on insolvency law.* Retrieved from: https://www.uncitral.org/pdf/english/texts/insolven/05-80722_Ebook.pdf
33. Wan Mohammad, W. M., Wan Yusoff, W. F., & Salleh, N. M. Z. N. (2014). Family ownership heterogeneity and audit committees independence and its implication towards the revised Malaysia code on corporate governance (MCCG, 2007). *Corporate Ownership & Control, 11(4-5),* 456-462. https://doi.org/10.22495/cocv11i4c5p3
34. Whisler, T. L. (1998). The role of the board in the threshold firm. *Family Business Review, 1(3),* 309-321. https://doi.org/10.1111/j.1741-6248.1988.00309.x