

# Management Control Practices and Professional-KIBS in Private Equity Field

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*This paper analyses a case study through a managerialist approach in order to investigate how private equity (PE) employs management control (MC) practices to support the knowledge transfer between professional-knowledge intensive business services (P-KIBS) and small and medium enterprises (SMEs). Furthermore, the paper highlights how SMEs face difficulties or barriers when adopting shareholder-oriented MC practices. Findings describe how PE works in a SME to reduce fails in shareholder-oriented MC practices due to limited resources and shortage of managerial expertise and how such practices are used by SME's top management or entrepreneurs to better estimate the effects of a partnership with P-KIBSs and monitor their development.*

*Keywords: Professional-knowledge intensive business services (P-KIBS), managerialist approach, Small and Medium Enterprises (SMEs), Management Control (MC), Dyadic inter-organizational relationship, private equity*

## INTRODUCTION

Globalization and business model innovation are relevant challenges for manufacturing small and medium enterprises (SMEs) (Brynjolfsson and McAfee, 2014). According to the European Commission, Knowledge-Intensive Business Services (KIBSs) have a crucial role for the growth of SMEs (Gotsch, et al., 2011). Compared with large companies, SMEs have limited resources and inadequate knowledge to improve their capability (Rajala, et al., 2008; Franco and Haase, 2015), and KIBSs may be a helpful means to integrate external knowledge-based resources (Kraaijenbrink, et al., 2007; Das and Teng, 2000). KIBSs can be described as “*services that involved economic activities which are intended to result in the creation, accumulation or dissemination of knowledge*” in the business-to-business industries (Miles, 2005; den Hertog, et al., 2011; Zhou, et al., 2016). KIBSs aim to develop, adapt, and transfer knowledge for various organizations (Castaldi, et al., 2013; Fernandes and Ferreira, 2013), playing a relevant role in promoting client firms’ knowledge search and improving their performance (Wagner, et al., 2014). They also contribute to interpret the tacit knowledge, which is an important component of innovation (Drejer, and Vinding, 2005).

In the relationship between KIBSs and SMEs, management control (MC) practices could play a relevant role. Some authors have focused on the MC practices outside boundaries of the organizations, such as inter-organizational cost management (Cooper and Slagmulder, 1999) and open-book accounting (Caglio and Ditillo, 2008). However, how MC practices can act as tool for the delivering of professional-knowledge intensive business services (P-KIBSs) among SMEs it has not been investigated in depth (Lopez and Hiebl, 2015; Wilkerson and Bassani, 2020). SMEs are often unable to afford specialized management knowledge in a short period of time (Brunswick and Vanhaverbeke, 2015; Mitchell and Reid, 2000). Therefore, MC practices are often less sophisticated and less formalized in SMEs than in larger companies (Quinn, 2011), and SMEs require MC approaches working with their resource constraints. In this vein, the paper aims to contribute to the existing literature investigating SMEs' difficulties and barriers when adopting shareholder-oriented MC practices (e.g., Marriott and Marriott, 2000; Hosworth and Westhead, 2003; McClhery, et al., 2005; Blume, 2016). To this end, Private Equity (PE) is a promising field to investigate MC practices in dyadic inter-organizational relationships. PE is defined as "*a financial intermediary (...) that invests only in private companies (...), taking an active role in monitoring and helping the companies in its portfolio (...) with the primary goal of maximizing its financial return*" (Metrick and Yasuda, 2011, p. 621). PE is seen as an alternative mode for the SMEs to obtain a service package of consulting and advisory services (Gilligan and Wright, 2014). During the "*investment stage*" (Talmor and Vasvari 2012), PE offers a complex bundle of service including managerial knowledge, strategic consultancy and MC design to the backed firm to assure the value creation for shareholders. In this vein, PE can be assimilated to P-KIBS because they heavily rely on professional knowledge and operate in the business-to-business industries in order to offer management and marketing services to develop value in the new technologies (Miles, 2005; den Hertog, et al., 2011; Horgos and Koch, 2008).

The study produces the following practical implications. First, it examines how PE works in a SME to reduce fails in shareholder-oriented MC practices because of limited resources, shortage of managerial expertise, and lack of adequate reporting and IT structures for implementation (Bahri, et al., 2011; Britzelmaier, et al., 2013; Garengo, et al., 2005). Furthermore, this study allows to highlight how PE firms improve structural intellectual capital through the implementation of MC practices (Sveiby, 1997). Second, it describes MC practices used by SME's top management or entrepreneurs to better estimate the effects of a partnership with P-KIBSs and monitor their development.

The remainder of this paper is organised as follows: section 2 outlines the literature about MC practices in PE field. Section 3 illustrates the research methods used for the case study analysis. Section 4 develops the discussion of the results. Section 5 shows the conclusions about the theoretical discussion and the practical implications in SMEs.

## **MANAGEMENT CONTROL PRACTICES IN PRIVATE EQUITY FIELD**

The use of MC practices by PE within portfolio firms is multiform (Kukla, 2011). It includes: human resource management practices (Bacon, 2008; 2012), compensation practices (Cuny and Talmor, 2007), performance measurement systems (Acharya, et al., 2009), diagnostic and interactive control systems (Bruining, et al., 2004), and target setting practices (Bloom, et al., 2015). The literature shows how PE-backed firms diverge from non-PE-backed firms in their use of MC practices, and how PE firms appear to be effective in monitoring practices (Bloom, et al., 2015; Acharya, et al., 2009; Bruton, et al., 2002; Bruining, et al., 2013; Kut, et al., 2007; Amess, et al., 2007). Another relevant stream of research goes beyond the comparisons between PE-backed and non-PE-backed firms, focusing on the heterogeneous nature of PE deals (Yeboah, et al., 2014; Wright, et al., 2009). Although PE literature widely describes several aspects concerning of MC practices to support the successful running of the deal, it seems to overlook how MC practices support PE firms in providing knowledge intensive services (Dello Sbarba, et al., 2020). However, Ferreira and Franco (2017) highlighted how strategic alliances and intellectual capital should be considered two key tools for technology-based SME. Previous studies have highlighted the relevance to combine different types of control (action, personnel and result controls) due to the type

of knowledge that managers and/or organizational units decide to share (Ditillo, 2012). Process-related knowledge, referring to the means and behaviors by which organizational objectives are accomplished (Turner and Makhija, 2006), is observable and it can be broken down into specific course of action due to its low causal ambiguity. Moreover, it can be moved in different business domains because it is not highly specialized (it derives from high knowledge relatedness characteristic). In front of these knowledge properties, action control is expected to be effective and MC can be implemented by formal documents such as operating manuals. On the opposite, if the knowledge refers to *specific technical know-how*, for instance, competencies and expertise incorporated into existing products and services, its content is not easily specifiable. It is difficult to list the elements characterizing the knowledge and identifying their relationships (it derives from high causal ambiguity characteristic). Furthermore, many aspects of the knowledge are tacit: hence, this knowledge can be transferred only through frequent and intensive contacts rather than through formal descriptions. In addition, it is difficult to transfer this type of knowledge among different business because of its high specialization (it derives from low relatedness characteristic). Due to these knowledge characteristics, personnel selection and training can help to transfer the knowledge. Lastly, *outcome-related knowledge* is about organizational results. When knowledge on outcomes is explicit, organizational results, targets and objectives can be specified. Instead, when such outcome-related knowledge is tacit, objectives and targets are characterized by greater imprecision. They may be subjective and based on understandings of the links between the activities necessary to achieve the expected objectives (high causal ambiguity) (Turner and Makhija, 2006; Ditillo, 2012). Managers are not able to know in advance what type of process produces a desired outcome; thus, they search modes for obtaining additional knowledge to achieve the planned results. Furthermore, the goals are measured in quantitative and often monetary indicators, because it allows to deploy and aggregate the results of different activities (Snell, 1992; Turner and Makhija, 2006; Ditillo, 2012). Due to these attributes, *outcome-related knowledge* is common to various business domains (high relatedness) and MC practices can be effective in sharing this knowledge. According to the literature, PE acting as P-KIBS transfers *specific managerial know-how* (e.g. specific managerial tools) and explicit/implicit *outcome-related knowledge* (e.g. strategic and financial goals are shared with the backed firm top management team and managerial skills are implemented in order to lead the backed firm). Hence, it is reasonable to expect that MC practices implemented combine different types of control (action, personnel and result controls) to support the knowledge transfer and reduce fails in shareholder-oriented MC practices.

## **RESEARCH DESIGN**

### **Methodological Issues**

We apply a case study analysis to a PE and its private equity-backed firm. We interviewed the General Partner of the American PE and the CEO of the PE-backed firm. The data was collected from a mix of archival data (website, guidelines, strategy documents, etc.) and meetings over a two-year period with semi-structured interviews. The interviews were administered with open-ended questions. Each interview was conducted by at least two authors, who took notes throughout. they were taped and listened to by all the authors independently (a summary of the scheduling of the interviews is provided in Table 1).

**TABLE 1**  
**A SUMMARY OF THE INTERVIEWS CONDUCTED**

<b>No. of interview</b>	<b>Interviewee</b>	<b>Type of interview</b>	<b>Total Length (minutes)</b>
1	CEO	Phone call	90
2	CEO	Phone call	60
3	PE (General Partner)	Phone call	90
4	PE (General Partner)	Phone call	60
5	CEO	Face to face	80
6	PE (General Partner)	Face to face	30

This case study, which describes a dyadic inter-organizational relationship focused on knowledge transfer, allows us to gather phenomenological evidence (Ferreira and Merchant, 1992; Scapens, 1990). Consistently with the managerialist studies (Malmi, 2016), we use Burkert and Lueg (2013)'s framework to provide a wide description of MC practices used to monitor PE professional support and compare it with the normative literature prototypes. This framework consists of six constructs: *Portfolio* refers to the presence of a long-term value maximization “rationale” behind strategic choices (Carr and Tomkins, 1998; Copeland, et al., 2000; Rappaport, 2001; Stewart, 1991); *Financial value drivers* refer to the availability of information about the financial components of the key financial indicators; *Nonfinancial value drivers* refer to the definition of drivers that link strategic determinants to the financial value drivers (Rappaport, 2001); *Action plan* attempts to measure whether managers define plans for achieving the key performance indicators (Dekker, et al., 2012); *Target setting* establishes targets aligned to the key financial ratios calculations (Malmi and Ikäheimo, 2003; Burkert and Lueg, 2013); *Mindset* measures the extent of the value-based culture in the company (Copeland, et al., 2000; Stern et al., 2001).

### **Case Description**

#### *The U.S. Private Equity*

The case study is focused on an American PE, established in 2001 in Manhattan, New York (NY), which has begun operating in the Italian market to create a *bridge between America and Europe*. The PE invests in firms with enterprise values between \$75 million and \$250 million. PE conducts U.S. investments through funds provided by institutional and individual investors. The case was selected according to the Kang and Sørensen (1999)'s potential factors of power: formal authority, social influence and expertise to assure the influence of PE on MC practices (see Table 2). *Formal authority* refers to power based on legal rights and includes the right to vote on nominations to the board of directors and the right to approve some major business decisions (Fiss and Zajac, 2004). The PE-backed firm was entirely owned by the PE, allowing the investor to exert a strong role in the diffusion of shareholder-oriented MC practices. *Social influence* refers to the frequency of interactions between the PE and the PE backed firm assuring the influence on resource allocation decisions (Pfeffer, 1992). The PE firm shows a high level of involvement and places qualified, loyal executives in the key operating positions (CFO and CEO). *Expertise* refers to the knowledge of the PE about managerial and business skills, which give legitimacy and enable PE to ensure follow-through in MC practices implementation (Kang and Sørensen, 1999; Pfeffer, 1992).

**TABLE 2**  
**“POWER” AND AUTHORITY OF PE FIRM**

<b>Ownership characteristics</b>	<b>Private Equity data</b>
Years in business (experience)	14
Acquired Stake (%)	100%
Level of involvement:*	///
1) Selection\replacement management	High
2) Obtaining additional financing	High
3) Formulating business strategy	medium- high
4) Implementation strategy	Low
5) Monitoring operating performance	Low
6) Acting as a “sounding board”	medium- high

\*Level of involvement has been collected by a questionnaire used during a semi-structured interview; the ranking has been assigned using a scale ranging from 1 (low) to 7 (high).

Source: Kang and Sorensen, 1999

*The Private Equity-Backed Firm*

The PE-backed firm was founded in Italy in 1960 to produce and distribute consumer-designed household equipment in the United States, the United Kingdom and Italy. It pursues a differentiation strategy, based on superiority in cleaning, laundry accessories, pet care, air care, drain care, fabric care, and lint removal product offerings. The success of the PE-backed firm hinges on a wealth of experience in manufacturing and distribution, and on an unwavering and pioneering sales and marketing approach through exclusive licensing agreements with world-class consumer brands. In 2012, PE-backed firm had revenues of approximately €50 million and total assets for about €35 million. Table 3 shows its strategic, size and technology features.

**TABLE 3**  
**DIMENSIONS OF PE-BACKED FIRM**

<b>STRATEGIC</b>	
<i>Position</i>	Differentiation Strategy
<i>Mission</i>	Build/Hold
<i>Pattern</i>	Analyser
<b>TECHNOLOGY*</b>	
<i>*Technology features have been assessed by a questionnaire used during an interview; the ranking is from 1(low) to 7 (high).</i>	
<i>Complexity</i>	Low
<i>Task uncertainty</i>	Low
<i>Interdependence</i>	Low
<b>SIZE</b>	
<i>Employees</i>	> 50
<i>Sales</i>	~ 50 ml
<i>Total Assets</i>	~ 35 ml

Source: Interviews and Archival Data

**THE ROLE OF MANAGEMENT CONTROL PRACTICES IN THE PROFESSIONAL - KIBS**

The findings show the changes in the MC practices in the SME from 2006. The new practices are implemented and used to support and monitor the relationship between the SME and the PE with the aim

at improving shareholder value. The findings confirmed that the PE monitored the key financial goal in terms of a multiple (enterprise value/EBITDA) and IRR (Internal rate of return). These indicators trained attention on two goals: the size and the timing of future cash flows. IRR was higher if cash inflows—which in the private equity industry only consisted of the exit price (calculated through multiples)—were larger in the short term. The PE considered also payback period (PBP) to verify value creation:

“At first instance, in alternative strategies evaluation, we use PBP, which must be at least less than three years” (CEO).

Although normative literature highlighted relevance to the performance measures based on discounted cash flow or residual income, the PE considered payback period to be the most important indicator, and the value measures (multiple and financial value drivers such as), provided a second-level check to verify actual value creation. Regarding the financial value drivers, the focus was on EBITDA, cash flow, invested capital (investment and working capital) and net financial position measures, totally disregarding the cost of capital:

“we used EBITDA, working capital, and net financial position. Therefore, we mainly focus our attention on creating operational cash flows and its impact on the net financial position” (CEO).

Based on value driver analysis, the CEO defined some key performance indicators with the purpose of evaluating how different business units, functions, and processes contributed to value creation. Our analysis revealed a predominance of financial indicators and a partial formalization of nonfinancial ones. There were no significant strategic changes that substantially modified the shareholder-oriented MC practices along the investment stage, and the CEO confirmed that the company only made changes to refine its existing indicators and follow the dynamics of business growth. With regard to target setting, the PE set goals based on a minimum level of performance needed to pursue value creation. The following statement of the PE represented an example of rationale adopted when it was selected the investment target level:

“At the time of acquisition of this company, we defined a minimum return expected from the investment in a specific period of time.” (PE)

In addition, the CEO defined targets among sublevels and reconciled them with the results at the corporate level. The definition of targets was based on a time horizon of three to five years. A forecast beyond five years was considered unreliable:

“Value creation is a medium-term objective because long-term prediction should be considered unreliable” (CEO).

To reinforce the shareholder value orientation, the PE defined a reward system linked to the results in term of value.

“Rewards are based on IRR above the hurdle rate and stock options. Therefore, the bonus depends on how much performance exceeds the minimum return expected from the operations. Furthermore, managers invest a part of their salary—earnings in the firms (e.g., 10 %)” (PE).

Consequently, also the CEO was remunerated in the variable component of the salary focusing on value creation.

“I am evaluated in terms of capital return above the hurdle rate at the exit of the fund. The PE defines two kinds of rewards for me: an annual reward based on EBITDA and net financial position targets and an exit reward based on the economic value creation at the exit stage” (CEO).

Periodical meetings were considered relevant to show data on shareholder value creation and to diffuse and reinforce the shareholder value knowledge:

“We usually report data on value creation during periodical meeting with managers and owners” (PE).

During these meetings were discussed the periodical financial results, so an outcome-related knowledge was shared between managers and owners (Turner and Makhija, 2006; Ditillo, 2012). Such practices help PE to support the provision of a service package oriented to improve the strategic and managerial knowledge of the SME:

“Our idea was to enhance the distribution channel of the company that had significant weight in America and strengthen the bridge between the old continent and America. It was a mile stone in the company's internalization.” (PE)

“We needed to distinguish ourselves from the mass of Chinese products. (...) The ethical protocols of the large retailers like Walmart and Target with which we work for demand several product requirements that we tried to afford. (...) We were the first producer of buckets made with maize...we were the first mover in our sector at the Frankfurt fair who promotes a differentiation strategy that combines sustainability (recyclable products) with the reduction of company costs. (...) Our idea was to differentiate ourselves producing products that would represent the “made in Italy” in America, so we could say “we made the Ferrari of the brooms”. (CEO)

In a context where a high sophistication is expected, PE measured shareholder value creation through a multiple (Enterprise value/EBITDA). The use of multiples suggests that P-KIBS preferred a less complex way to monitor the shareholder value, using them over periodical value-based performance measures (e.g. residual income) and over discounted cash flow methods (based on income or cash flows). The cost of capital was not included in the periodic financial indicators, despite the great emphasis that normative literature highlights to this metric (only in the initial business plan, the strategic planning was based on traditional discounted cash flow method). The value creation was shown through well-known performance measures (i.e. discounted cash flows and IRR). During the management stage, the MC practices were simplified and PE controlled if targets were achieved by multiples and internal financial drivers. The alignment of value creation target to the capital market was guaranteed by monitoring financial drivers and multiples. This way to implement shareholder MC practices avoided at least two criticisms of shareholder MC practices that often caused the abandonment of this type of management control system (see for instance McLaren et al, 2016). First of all, the cost of capital, a measure that is not easy to calculate (and understood) for in SMEs, was not included in the MC practices. Secondly, value creation indicators were not formally linked to their drivers; this connection is a pillar of shareholder approaches (Rogers, 2003), but again is not easy to realize and to use. Despite these choices, MC practices did not produce apparent problems and they were effective. In fact, MC practices were designed and used to satisfy the main information needs of PE and backed firm managers. As underlined before, the shareholder value creation process was monitored through the multiple. Instead, traditional performance measures were used within the backed firm to measure drivers of the multiple. These measures were well known by the managers of the backed firm, so PE exploited this high degree of financial knowledge relatedness. This allowed to monitor effectively the main financial value drivers.

Furthermore, the PE considered mindset an important component of the MC framework: it was the springboard for proper implementation and operation. PE carried out meetings with managers to control and to sustain the value creation process, which presented a high level of causal ambiguity. In this way, PE transferred tacit knowledge regarding financial performance measures and developed shareholder value practices without using a tight and sophisticated MC system. In addition, PE relied heavily on personnel control (managers recruiting and training), in order to control financial results, to understand in depth their determinants, to mobilize its managerial and strategic knowledge reputed useful for shareholder value creation and to diffuse a shareholder mindset. The new CEO pinpointed that was essential to act on the personnel side of control practices to have an effective strategy and managerial implementation. The CEO pointed to the diffusion of a shareholder perspective among employees as one of the main contributions to the implementation of shareholder-oriented MC practices:

“My job was bringing leadership and managerialism in order to drive the acquired firm toward shareholder value creation” (CEO).

The PE acquisition of the PE-backed firm introduced an insight that can be defined as “value-oriented intelligence” which focused managerial attention on classic financial measures (e.g. EBITDA) as the main value drivers.

“According to me, the explicit goal of creating value, in terms of multiple, is a largely practice among PE funds, and it is based on the improvement of EBITDA” (PE).

PE considered mindset as the most important component of shareholder-oriented MC framework, believing that sharing knowledge on shareholder basic principles through a business plan was a critical factor for an effective implementation of shareholder-oriented MC practices in the PE-backed firm. Reward systems linked to the results (in terms of value) were essential to enforce goal congruence and to develop a value-oriented mindset.

Finally, expertise represented the most valuable element in explaining the relatively less shareholder-oriented financial control sophistication. PE appointed a CEO and a CFO with a strong financial/economic background (Table 4), realizing a form of personnel control.

“We selected managers to achieve our goals. Our managers who we hire in the PE-backed firm must work in two alternative ways: they only do what we say, or they do what we say with brilliant intuitions. We avoid intermediate solutions because it is just a waste of time!”

Their background allowed them to play an active role in implementing the standard model provided by the PE and working together to develop MC practices; they transferred knowledge to the employees.

“Although a basic standard model was provided by the PE, we implemented and adapted the control system into the company (...) then we continued to improve it in order to have more detailed information on efficiency. But if you want to ensure that the model works well, you need to have people with right skills” (CEO).

**TABLE 4**  
**CHARACTERISTICS OF CEO AND CFO IN PRIVATE EQUITY-BACKED FIRM**

a)	CEO background	Degree in economics
b)	CFO background	Degree in accounting and finance
c)	CEO tenure	1-5 years
d)	CFO tenure	1-5 years



About the role of the actors involved in the design and use of the shareholder-oriented MC practices, it emerges that the financial-oriented ownership and its expertise remained fundamental for the development of the basic model of shareholder-oriented MC (e.g., based on multiples) while the two managers of the SME played an active role in defining its extensiveness (Burkert and Lueg, 2013).

## CONCLUSIONS

This paper investigates private equity (PE) employs management control (MC) practices to support the knowledge transfer between professional-knowledge intensive business services (P-KIBS) and small and medium enterprises (SMEs). First, this study analyses the history (between 2006 and 2013) of MC practices used to support the relationship between this P-KIBS and its related SME. In a context where a high sophistication is expected, the case study reveals that sophistication is not considered desirable *per se*. P-KIBS needed a clear and not too much sophisticated MC in order to have a high degree of relatedness between the existing knowledge in the SME and the knowledge transferred. The adoption of a simple financial measurement approach allowed to have a high degree of relatedness with the financial knowledge existing within the SME. Secondly, we contribute to the existing literature that highlights how SMEs face difficulties or barriers when adopting shareholder-oriented MC practices (e.g., Marriott and Marriott 2000; Hosworth and Westhead 2003; McChlery, et al., 2005; Blume, 2016). In doing so, this paper shows the peculiarities of MC practices implemented in the SME in order to transfer relevant managerial knowledge when there is no need for SME to communicate explicitly and formally firm goals and strategy, or when it is not possible due to the tacit nature of knowledge. In particular, this research allows to highlight how PE firms improve structural intellectual capital through the implementation of MC practices (Sveiby, 1997; Ferreira and Franco, 2017). MC practices promoted by P-KIBS include, not only result control carried out by a traditional financial approach, but also personnel and, at minor extent, process or action control. In particular, personnel controls are realized by recruiting new managers, training employees and activating direct relationships between owners and managers. This allows P-KIBS to introduce a “value-oriented mindset”, considering the relatedness and causal ambiguity of knowledge transferred through its services. Finally, managers were not the only staff exerting influence on MC practices, but they also hired professional finance and accounting staff that could be expected to be important for the professionalization of its SME (Ritchie and Richardson 2000; Davila 2005; Davila and Foster 2005, 2007). The P-KIBS as PE owner selected the managers introducing new ones in order to facilitate the transfer of managerial knowledge without making such tacit knowledge explicit. The findings allow a deeper understanding of the role of the actors in designing and developing MC practices showing that the PE picked the essential characteristics of MC practices (the basic level of fidelity), while management determined its extensiveness.

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