

# Challenges in Corporate Governance – A Family Controlled Business Prospective

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**Abstract**— Family Controlled businesses carry the weight of economic wealth creation in most economies. In the U.S. alone, family businesses account for 80 to 90 percent of the 18-million business enterprises in the United States, and 50 percent of the employment and GNP. In India family controlled business are 85 to 90 per cent of total corporate entities which contributes 75 per cent of employment, 65 per cent of GDP and 71 per cent of market capitalization. The situation of other countries is not diverse from US anyway. Rapid growth and globalization has increased risk level for family businesses to run and survive for long life. Founders who had dreamt to build family empires started many of today's large corporations. By adopting sound corporate governance mechanism, many of these challenges can be tackled or fetch in bottom. In this paper, we describe the importance of corporate governance in family owned business and challenges facing these businesses in new era. Organizations are especially susceptible to loss of vision and purpose during periods of CEO transition, as the leaders who facilitated shape the vision are replaced by others who may not share the same values and capabilities. This paper also addresses the importance of understanding business succession planning and challenges involved by traditional ways of succession planning and firm effectiveness in the family business.

**Index Terms**—Corporate Governance, Family Controlled Businesses & Grim Challenges.

## I. INTRODUCTION

Highlight Family Controlled Businesses (FCB) shape the building block for businesses across the Global. The economic and social importance of these family firms has now become more widely recognized. Internationally these firms are the dominant form of business organization. One measure of their dominance is the proportion of family enterprises to registered companies; this is estimated to range from 75% in the UK to more than 90% in South Asia, Latin America and the Far and Middle East.

The ways by which these firms are directed and controlled is therefore crucial and mainly represent the norms of family founded and respective legislation enforced in domestic state.

Family Controlled Businesses included all enterprises that are owned, controlled or drastically influenced by a specific family or families and having a significant dominant position in firms' equity. These firms are founded by the current top executives or their fore fathers. This is the case when the family has the final say in whoever is responsible for managing it. In the same way, it makes sense to treat family firms as an international business form, on the basis that they face similar opportunities and problems and that those similarities outweigh the national and cultural differences

### *Family Controlled Business is:*

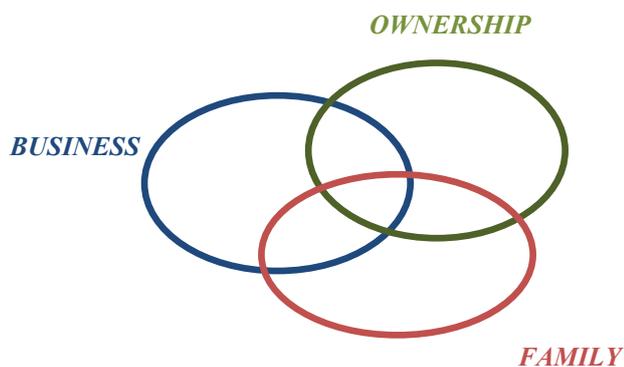
- 1. The majority of voting power share belongs to a natural person, his spouse or other family members.*
- 2. The ownership of votes may be indirect or direct.*
- 3. At least one member of the family, or his legal representative, is in charge of the company management or governance.*
- 4. Listed companies fulfill the definition of a family business if 25% of the voting power shares belong to a single person or his family member. Indirect voting power in a listed company must belong to the family.*

between them.

The governance of a family firm is in many ways more harsh and complex than the governance of a firm with no family involvement. Family relationships have to be managed in addition to business relationship usually.

In sinister side, investors in companies with controlling family ownership are at risk of anecdotal degrees of expropriation, mainly through the family procuring confidential benefits at the price of the other shareholders, including related-party transactions on noncommercial terms and the transfer of the company's assets to other companies owned by the family. Research into the Italian stock market shows that the high risk of expropriation connected with concentrated ownership can negatively affect a company's value when the ultimate owner is either the state or a family. While expropriation represents conceivably the most severe risk in family ownership structures, other less severe risks are also relevant to credit risk and financial health more generally.

Corporate governance is a blend of the internal and external corporate governance mechanisms. The external mechanisms include the managerial labour market, the capital market, takeover and legal protections/systems. The internal governance mechanisms include the board of directors and most important is ownership.



Good corporate governance strengthens and elucidates the activities of the family Controlled firm while improving its competitiveness. Proper functioning and transparency of the roles and responsibilities of all organs in the firm are defiantly in the interest of the owners, other stakeholders and the whole company.

But apart from the lengthy systems and processes that one puts in place, it is really the spirit of practice that defines the essence of the concept.

## II. TO GIVE A PRACTICAL PERSPECTIVE

Family businesses range from Cluster Companies and Small and Medium sized companies to large Group of companies that operate in multi range industries and countries. Normally businesses are founded in small level and after the passage of time and getting value for its unique core values and become listed companies. Some of the well-known family businesses include: Salvatore Ferragamo, Benetton, and FiatGroup in Italy; L'Oreal, Carrefour Group, LVMH, and Michelin in France; Samsung, Hyundai Motor, and LG Group in South Korea; BMW, and Siemens in Germany; Kikkoman, and Ito-Yokado in Japan; Tata, Reliance and Birla Groups in India, and Saigol, Dewan, Mansha and Hashu Groups in Pakistan and finally Ford Motors Co, and Wal-Mart Stores in the United States.

It is also a true fact and proved by research that most family businesses have short life length beyond their founder's stage and that some 95 per cent of family Controlled businesses do not survive to the third generation of ownership. This is often the consequence of a lack of grounding of the subsequent generations to handle the demands of a growing business and a much larger family in fact. Family Controlled Firms can improve their probability of survival by setting the good governance structures and by starting the edifying process of the subsequent generations in this era.

The need for sharp Governance has been amplified due to globalization which brings many opportunities on the cost of bulky risk aspect.

With collapse of some of the prominent companies in the early 90s in England that triggered the thinking behind corporate governance especially Family controlled firms which are already in ante. There was a lot of anxiety in the British public because none of their Annual Reports, before the crash gave any indication of the poor financial status of these businesses. To show ideal growth and profitability

many companies were exploiting the weakness in financial reporting and present a better picture than what was really the case. In many of them the Boards had shrunk and the roles of the Chairman and Chief Executive were combined so that one man show was practically ensuing in company. However brilliant the person, there was a growing realization that no one individual could be 'right' all the time and needed guidance from independent Board members.

Britain had always enjoyed the reputation of being a dependable financial centre and the London Stock Exchange was concerned that if some steps were not taken this reputation, built up over the years, would get worn. A Committee set up in 1991 under the chairmanship of Sir Adrian Cadbury published a report on the Code of Best Practices. What is interesting is not that, this was not a mandatory Code for all public companies and the Code had no legal binding – nor was it prescriptive. As well in US the Sarbanes Oxley Act (2001) introduced after shocking waves of chaos corporate completion, collapse of Enron and WorldCom.

McKinsey studied and demonstrated the value creation process of Good Governance. It has been argued that distant from the ethical aspect of being accountable to shareholders and stakeholders, there is a business vital too, as transparency has a major competitive advantage - winning investor's trust and confidence. According to the McKinsey report, investors in emerging markets are willing to pay as much as 30% more for shares in companies with good corporate governance.

Companies incorporating even a single element of governance can expect a 10% to 12% boost to their market valuation. However, we follow corporate governance not merely because it gives a business advantage but because it makes good business sense – something that owe to stakeholders.

A Harvard/Wharton study showed that if an investor purchased shares in US firms with the strongest shareholder rights, and sold shares in the ones with the weakest shareholder rights, that investor would have earned abnormal returns of 8.5 percent per year. Not only this U.S based firms with better governance have faster sales growth and were more profitable than their peers.

What are some of the issues that crop up in a Family Business?

### A. Board

There are two aspects:

- Structure of the Board
- Role of each Board member

Board must takes independent/unbiased decisions; the board members are the 'trustees' of the shareholders, especially the minority – entrusted in providing transparent data, taking decisions in the best interest of the 'shareholder'.

When it comes to board membership, most family Controlled businesses reserve this right to members of the family and in a few cases to some well trusted non-family managers. This practice is generally used to keep family control over the direction of its business. Indeed, most decisions are usually taken by the family member directors. Family directors who are also managers in the business

would naturally encourage reinvesting profits in the company so as to increase its growth potential. On the contrary, family directors who do not work in the business would rather make the decision of distributing the profits as dividends to family shareholders. These gainsay views can lead to major conflicts in the board and negatively impact its way of functioning.

A board also offers a means of safeguarding the solidity and continuity of the firm. An organization based on informal family relationships and business relationships is at risk from unexpected rows or losses in the family. A board is better placed to deal with such shocks to the system and to adapt to inevitable changes in the business environment than a more hierarchical structure. It can provide for continuity by bringing members of the next generation into the board's council at an appropriate stage and by setting down the firm's beliefs and policies for their guidance.

### *B. CEO Duality*

As In selecting the CEO of a company, one would want the organization to be run by the 'most competent' person with professional knowledge and experience.

Being employee of firm The CEO has accountability and responsibility to the organization and its shareholders. He or she should be able to be questioned by an 'independent' authority called the Board or Chairperson of the company. In a worst case situation if found unsuitable, he/she is asked to relinquish the position.

Practically, it is when the CEO is a family member; this becomes quite difficult and awkward which can create further unsuitable problems for management and as a whole business. This family CEO believes that being owner of majority share owner he has full right for different experiments as well to do according to their force.

Secondly, if the CEO and Chairperson is one and the same, we get into the same mayhem, since he is the authority within the organization as well on the Board. To avoid such compromises, it is recommended by all Codes of Corporate Governance in intact world that the two roles be handled by separate individuals.

In a Family Business, very often, it is the entrepreneur who is the "Chief Business Owner" – all in one; giving up a position, even to hand it over to the next generation is a tough one to crack and therefore complications set in.

### *C. Succession Plan*

A change of guard or succession is a complex and stressful event for any business and in the case of family businesses it gets extra complicated. In Pakistan, irrespective of whether the inheritor is competent or not, there is a tendency to expect family members to run the Business. This attitude prevails in the political field too, as can be seen in the case of many of our parties. The situation can get worse when all the siblings aspire for the top slot, and can even be disastrous when the siblings remaining within a single fold pull in different directions.

On family business, there is a saying – "the first generation creates, the second inherits and the third destroys".

Two words "Succession Planning" seem so simple and easy to follow and yet it is so difficult because it means coming to terms with the fact that you are not indispensable.

However great a leader may be, he/she has to realize that the organization is larger than the individual, that it has an ongoing life of its own, irrespective of who heads it. A leader has not been successful if the organization cannot manage without him and fails poorly after his exit.

The best legacy an outgoing family leader can bestow on the next generation is to ground them in the values appreciated by the family, and that are valued as the hallmark of that organization. For example, values like passion for quality, customer-focus, professional integrity or giving back to Society. Smooth succession can be an important value that can save many family businesses; and is certainly a very important aspect of governance.

There should be joining and exist rules for family members but the most important is that the succession for "C" level executives must be predefined.

It is worthwhile to remember the rationale given by Sir Cadbury. He said,

"The important reason why I believe it is vital for enterprises to set and maintain high ethical standards are that good companies attract good people".

### *D. Internal Control Formation*

Weaknesses in Corporate governance structures of family businesses are most evident in internal controls, implementation of effective internal audit and realization of risk management. Since many families Controlled businesses are managed by the founders or their children, with their close supervisor the control environment is largely customized to their needs and according to their indulgent. The problem come when controls do not grow along with the company, as the businesses grow with the passage of time and situation becomes more complex. This space is a crucial spot of concern for external investors for their decision making and long term survival.

"Walking the path of true institutionalization and creating value with it requires a powerful level of commitment, internal control and high corporate governance practices are critical tools to get this job done."

Gerardo De Nicolás, Homex, CEO

### *E. Family Constitution*

Weaknesses Family constitution is a living document that evolves as the family and its business continue to grow. As a consequence, it is necessary to regularly update the constitution in order to reflect any changes in the family and/or the business.

However, a typical family constitution will cover the following elements:

- Values, mission statement and vision as core value for business.
- Board of directors / Board of trustees.
- Executive management.
- Authority, responsibility, and relationship among the family, the board, and the senior management.
- Solution in the case of conflicts.
- Policies regarding significant family issues such as family members' employment & transfer of shares, succession planning, Chairman tenure and nomination, etc.

In fact most family businesses don't have a appropriate

constitution, they usually have an informal set of rules and customs that determine the rights, obligations, and expectations of family members and other governance bodies of the business. With the growth of family business, it becomes crucial to develop a written and formal constitution that is shared among all family members to shun the conflict among family members.

Family governance structures and institutions require a certain degree of formalization if they are to function well. As families adopt policies on the family's approach to the business and on governing the business, they will formalize these efforts with documents that will differ depending on their ownership stage.

### III. INITIAL STAGE

Typically, in the prior stages when the company is governed by the founder or his/her children, defiantly many aspects of family and business governance are informal. Any efforts to formalize relate mostly to the business itself by owner manager. First attempts at written policies usually are brief documents that state a general family vision and mission with respect to the company. In this stage founders decide and set their explicit regulation which reflects the personality of these owners and some time according to their social identification.

### IV. MIDDLE STAGE

This level comes with the requirement to develop a family employment policy. This becomes more visible when the company reaches the sibling partnership stage. The family employment policy sets clear policies on terms and conditions of family employment within the firm. For some families, these rules instruct conditions of entry, retention and the way to exit from the business. The policy also should cover the treatment of family member employees vis-a-vis non-family employees.

### V. ADVANCE STAGE

In third, fourth and succeeding generations, family businesses can scarcely survive unless full family governance policies are undoubtedly written and communicated within the family and the business, as well as to other outside stakeholders. The document covering all of these policies is commonly called a family constitution.

"Family Creed" document expresses the family's ideology regarding the family loyalty to core values, vision, and mission of the business with it heart. It often defines the roles, compositions, and functions of family governance institutions and the company's own governance bodies, such as the shareholders' meeting, the board of directors, senior management position and non executive owners of the business who want to earn dividend only.

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Assessing Corporate Governance In Family-Controlled Companies From A Debt Holder Perspective. Some aspects of family control may be beneficial for creditors: Potential strength. Outside of the business. High standards of mandated disclosure Voluntary disclosures. 2 January 2008, Special Comment, Moody's Corporate Governance "Assessing Corporate Governance In Family-Controlled Companies From A Debt Holder Perspective. Special Comment. Moody's Corporate Governance." Family-controlled companies can be better placed to make fast decisions, when required, due to the informality of decision-making and the central role played by key family members. The main challenge in the governance of family-owned businesses is the existence of the additional layer of complexity that the owning/controlling family brings to the business. Shareholders must learn to understand the various interconnections among the owning/controlling family members. Recruitment and Promotion - Recruitment and human capital management are major factors in a family firm's long-term success. A governance system that provides clear guidelines for employing family or non-family members and impartial performance-based promotion is essential for the sustainability of the business. Typically, first-generation family businesses are managed by the founders and other family members, and this may continue to the second generation.