How Good Governance Helps Family Businesses in Smooth Transition from Generation to Generation

Around the world family owned businesses play a vital role in a country's economy. Statistics show that over 70% of businesses in the Pakistan are either family-owned or controlled, demonstrating that this business model is the essence of local societies and regional economies. As such, they play a vital role in economic development – not only through their business contributions but also by creating an investment environment that is open, safe, secure and transparent. [1]

However, they face a unique set of challenges that are rooted in an organizational structure that prevents these enterprises from:

- attracting and retaining high quality human capital,
- obtaining lower cost debt and equity capital, and
- ensuring long term competitiveness and sustainability.

Apart from the above, the one factor which damages the growth the most is investing a huge quantum of personal interest in the success of the business which leads to an unwillingness to take risks such as expanding and diversifying into new business ventures.

Though being an integral part of any country's economy, it is a fact that most family businesses are carried only up to the second generation, hardly 15% continue or survive to the third generation. Of those that do, 85 percent either collapse or completely cease to exist before the fourth generation takes charge. The often volatile mix of personal and family dynamics can create a difficult situation to handle. Differing visions and objectives among family members can create conflicts and compromise the governance of the firm. The potential for conflict grows as the family structure experiences changes, succession and power issues across expanding family particularly with the emergence of the second and third generations can create cascading concerns.

Like any other economy, in Pakistan the contribution of family businesses is enormous and form the back bone of its industrial structure. As per a survey in 1950s and 1960s there were about 22 prominent family businesses but only a few managed to retain their prestigious position. In Pakistan most family owned company are registered as private limited companies and operate as closed groups lacking objectivity and an independent view.

The principles of good corporate governance are useful for all types of companies whether listed or otherwise. In Pakistan the Code of Corporate Governance is only applicable to the listed companies but advantage of the same can be enjoyed by non -listed companies. By adopting sound governance principles such businesses can increase their efficiency and performance resulting into sustainable growth and prolonged continuity. In 2013 a draft Principles of Corporate Governance for Non-Listed Companies was issued containing thirteen principles on the basis of a dynamic phased approach taking into account the size of individual company. Applicable on voluntary basis these principles would have provided a governance road map to such companies. Unfortunately it remains a draft to this date.

[1] *Pederson & Partners- Executive Search*

Today the awareness level is very high. Investors place strong emphasis on recognizing good practices resulting in more transparency and providing greater protection to the minority shareholders. Along with the multiple advantages of having a flourishing family business there is a long list of challenges which need to be addressed.

- acquiring low cost capital
- auxiliary growth and business diversification;
- managing ownership and leadership transitions;
- developing the next generation of business managers/directors

Good family and business governance must work side by side to obtain sustained benefits.

"It is important to teach each new generation, early on, the difference between ownership and stewardship. Ownership is a right of possession. Stewardship is a fiduciary role. It is holding the institution in 'trust for' the next generation. We feel, as a family, that this institution has been passed on to us for our care and not for us to dissipate or do what we will with it for our personal gain." [2]

To address challenges posed by the unique business structure and its assimilation in mainstream economics, adoption of corporate governance measures is the only route to ensure long term success of such businesses. From an investor perspective, the key is to establish the right corporate governance conditions so that the positive aspects of family ownership are coupled with assurances that investor interests will be recognized and addressed.[3]

Family ownership may be seen as an opportunity or a threat, depending on a variety of factors. The family ownership and commitment to the business may be understood as adding value, provided that the company and the controlling family can respond to the concerns of the investor community. Investors—both shareholders and creditors—may look with distrust on family-controlled companies, because of the risk that the controlling family may abuse the rights of other share-holders. So investors likely will scrutinize such companies with care before taking the plunge and investing. There is a long and storied history of family-owned companies with highly-concentrated ownership, poor transparency and absence of accountability and fairness principles that led to abuse of minority shareholder rights.[4]

Steps to Improve Governance System:

Board of Directors:

Family owned companies are classified as companies where almost all the shareholders belong to the same family or have strong family connections. While electing the board members careful attention should be paid to the mix of directors, executive and non-executive/Independent Directors. Having an independent director on board is always considered as a best practice but has little effect in real terms.

In the present times it is paramount upon family businesses to induct 'truly' independent directors on their boards to allow objective evaluation of the management's performance and well-being of the company without any conflict of interest or undue influence of interested parties. Family members on the board must let their executive actions open to scrutiny. They must be willing to be questioned on their business proposals and decisions.5

There are many good reasons to bring independent directors on board of which few are:

- To bring in expertise and diverse knowledge pool

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[2] *Jaime Augusto Zobel de Ayala, Ayala Corporation, Philippines, Founded in 1834*

[3] *Governance Challenges for Family Owned Business, IFC*

[4] *P.I.C.G (Pakistan Institute of Corporate Governance) "The Corporate Governance Guide--- Family-Owned Companies" Practical Guide to Corporate Governance "Governance Challenges For Family owned Businesses" chap 5 pp. 121-144*

[5] *Independent directors for a family business* by John Wood and Thames Fulton, Heidrick & Struggles Governance Letter

- As mentors -coach and counsel family members on legal, technical and financial matters.
- To bring in objectivity and a '**voice of reason**' that counterweighs family factionalism and historical bias[6]
- Brings in external perspective on strategy and control and to have a financial oversight on the performance of the company
- Prove to the outside world their commitment to transparency and accountability.

Family Governance

Ownership and exercise of rights of all shareholders, including minority shareholders, should be respected and protected by forming a functional family council. Observing shareholder rights is necessary for a company to function and grow. A family council can act to preserve these rights in companies where: shares are held by several family members; shares are held within several branches of the family; or, within a single branch of the family, multiple generations are involved in various roles in the company.[7]

Role of other stakeholders

Other stakeholders would majorly include the management/employees of the company. The success of any company depends on an efficient management team. It should be ensured that the employees are treated fairly without discrimination and are appreciated and well rewarded. The company must recognize the role and rights of all its stake holders.

Disclosure and Transparency

The company should be governed ethically and in a transparent manner. The largest failures in business history such as Enron and Parmalat, was mainly because of the poor disclosure of the financial statements of such corporations. Sir Cadbury stresses that fairness and transparency in financial and non-financial perks and reward systems, particularly within the family, is an essential tool in avoiding tensions over perceived injustices. The board of directors should appreciate the role of the employees, especially key management, in the success of the company and should ensure that employees are treated with fairness and equity and without discrimination. The company should recognize the role and rights of its stakeholders, both through established laws or mutual agreement, and should encourage active cooperation to achieve operational and financial sustainability.

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[6] *Independent directors for a family business* by John Wood and Thames Fulton, Heidrick & Struggles Governance Letter

[7] International Journal of Innovation, Management and Technology, Vol. 1, No. 2, June 2010
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