Journal of Contemporary Management
Submitted on 17/Oct./2012
Article ID: 1929-0128-2013-01-66-07 Shagufta Kashif, and Saima Siddiqui

Corporate Governance for Family Firms: An Essential Move towards Optimal Organizational Performance and Growth

Shagufta Kashif
College of Business Administration, University of Dammam
Tel: +966568805410 Email: shugufta_rashid@hotmail.com

Saima Siddiqui
Department of Business Administration, University of Sindh
Tel: +923323898617 Email: ssiddiqui.su@gmail.com

Abstract: This paper examines the importance of Corporate Governance to the family owned corporations and businesses in Pakistan. The author starts with discussing the importance of Corporate Governance itself for smooth functioning of a Family-owned Business as well as the lucrative opportunities, the compliance can bring to the firm and the country as a whole.

Moving forward, the writer analyses the challenges faced by these firms in ensuring transparency and due diligence and in the end, the researcher presents recommendation.

Family-owned corporations are the backbone of many countries especially Pakistan where the power culture has concentrated the wealth of the nation in the hands of “22” families as identified in the Ayub era. The way these corporations behave in the economic world can affect the overall economic conditions of Pakistan and also take the country to a new level in terms of favourability in the books of foreign investors. With the advent of new technology and the rise of the impact of globalization, there lie numerous opportunities for these firms to prosper. However, at the same time if these corporations need to go international or global, then they have to be sound followers of Corporate Governance practices which can bring them in line with international standards of transparency and good governance. New global markets can open for the firms themselves as well as foreign investment can flow into the country as the standard bar for the country is raised. This study overall examines the theoretical background of Corporate Governance in family businesses in Pakistan.

JEL Classifications: G38; M21

Keywords: Family owned business (FOBs); Family owned firm; Corporate Governance in Pakistan

1. Introduction

Businesses around the world need to be able to attract funding from investors in order to expand and grow. Before investors decide to invest their funds in a particular business, they will want to be as sure as they can be that the business is financially sound and will continue to be so in the foreseeable future. Investors, therefore, need to have confidence that the business is being well managed and will continue to be profitable. In order to have this assurance, investors look to the published annual reports and accounts of the businesses and to other information releases that the company might make. They expect, that the annual report and the accounts will represent a true picture of the company’s present position---- after-all, the annual report and accounts are subject to an annual audit whereby an independent external auditor examines the business’ records and transactions and certifies that the annual report and accounts have been prepared in accordance with accepted accounting standards and give a 'true and fair view' of the business' activities.

There have been a number of high profile corporate collapses which have arisen despite the fact that the annual report and accounts seemed fine. These corporate collapses have had an adverse effect on many people: shareholders who have seen their financial investment reduced to nothing, employees who have lost their jobs, and in many cases the security of the company pension which has also evaporated overnight. Therefore, the audited financial statements are not just the only information that stakeholders can rely on. Alternatively, the other form of Corporation which is a family owned corporation, the regulatory authorities in many countries do not have a strict regulation in terms of auditing and disclosing their financial information and therefore there is a greater probability of information being distorted to their benefit.

According to PICG, Family owned companies are characterized as organizations where nearly all the shareholders belong to the same family and participate substantially in the management, direction, and operation of the company (Pakistan Institute of Corporate Governance, 2008). In another place, "*A family business refers to a company where the voting majority is in the hands of the controlling family, including the founder(s) who intend to pass over the business to their descendants*" (Abhouzaid, 2007). Family firms are companies in which one of more families linked by kinship, close affinity or solid alliances hold a sufficiently large share of risk capital to enable them to make decisions regarding strategic management (El-Din, 2008).

Family owned businesses are often regarded as the dominant form of businesses around the world. Ranging from small family businesses to large business entities employing hundreds, or even thousands, of staff, they can encompass sole traders, partnerships, private companies and public companies. As a matter of fact, family ownership is prevalent not only amongst privately held firms but also in publicly traded firms in many countries across the globe. However, irrespective of the size of the business, it can benefit from having a good governance structure. Firms with good governance structure will tend to have a more "focussed" view of the business, be willing to take into account and reap the benefits from the views of outsiders and consequently be in a better position to evolve and grow in the future.

Many countries are realizing the fact that as business grows and needs external finance to pursue its expansion, and then non-family investors will only be attracted to the business if they see that their interests are safeguarded. Therefore, they are looking towards the Corporate Governance resort to force companies introduce transparency in their records as well as to protect investors' finances.

Many of the world's most famous large corporations of today have started as family-owned businesses, examples include, Acer Computers, Wal-Mart, Ford Motor Company, SC Johnson, Tetra Pak, Anheuser-Busch, Cadbury, etc.

La Porta, et al. (1999) analysed the ownership structure in a number of countries and found that the family owned firm is quite common (La Porta, et al., 1999). Working with a sample of large firms in 27 countries, the researchers used a ten percent chain definition of control as one of their criteria and it was found that only 24 percent of the large companies are widely held, as compared to 35 percent that are family-controlled and 20 percent state controlled. La Porta et. al.'s paper made an important contribution to our understanding of the prevalence of family owned/controlled firms in many countries across the globe.

In recent years, the debate on Corporate Governance has taken its toll and is spreading like wildfire, causing it to gain high visibility at all levels including social, economical and academic. The key purpose of Corporate Governance is to promote accountability, transparency, fairness, disclosure and responsibility (Wang, et al., 2010).

2. How Can Corporate Governance Help?

Corporate Governance helps countries and companies attract investment from around the globe as investors consider companies practicing good governance being safer. It also strengthens the foundation for long-term economic growth. Following are some of the requirements of Good Corporate Governance and their effects.

(1) Transparency: Corruption and non-transparency drains a company of its image as well as long-term prospects, while driving investors away. Therefore, by demanding transparency in corporate transactions, Corporate Governance attacks the core of corruption and is a major source in eradicating it from its roots.

(2) Improving Management: Corporate Governance helps managers to make sound business decisions and formulate strategies that are in the best interest of the organization and the stakeholders. This improvement in decision making and managing helps companies to attract investment on favourable terms and enhances performance of the company.

(3) Standards and Procedures: Corporate Governance favours formulation of standards and procedures to deal with crisis that hit capitalist economies after every decade or two. By adopting standards to deal with investors and creditors, this prevents banking crisis as well as business failures

(4) Safeguarding minority shareholders: For countries that are trying to attract small investors (foreign or local), Corporate Governance matters a great deal on getting the finances out of their pockets. Research has shown that countries with stronger corporate governance protections for minority shareholders also have much larger and more liquid capital markets.

Hence, Good Corporate Governance

- Reduces risk
- Stimulates performance
- Improves access to capital markets
- Enhances the marketability of goods and services
- Improves leadership
- Demonstrates transparency and social accountability (CIMA Handbook, 2012).

3. Corporate Governance in Pakistan

In Pakistan, awareness of the importance of good governance is prevalent among policymakers and standard setters. Regulatory bodies including SECP (Securities and Exchange Commission of Pakistan) and SBP (State Bank of Pakistan) issued a Code of Corporate Governance in 2002, most of which was relevant for listed companies. In addition to above, as a result of a public-private partnership, PICG (Pakistan Institute of Corporate Governance) came into being. PICG has been very active in the dissemination and implementation of Corporate Governance by organizing seminars, conferences and knowledge groups to share knowledge related to good governance practices. The SECP has also become very active in enforcing its strong authority under the law. Recent years have experienced imposition of penalties, introduction of new regulation as well as awareness. In 2008, PICG drafted *The Corporate Governance guide for Family-Owned Companies* which provides a Corporate Governance framework, based on internationally recognized principles, which are practical and adaptable for both listed and unlisted companies.

4. Family-owned Businesses (FOBs) in Pakistan

The country has experienced phenomenal growth in the past few years in terms of increase in the number of unlisted companies, especially FOBs. The Securities and Exchange Commission of Pakistan has recently reported that there are more than 50,000 unlisted companies. Although family-owned businesses enjoy a close network of owners who also serve as directors, through which the process of decision-making and strategy implementation is quick, they are generally unable to sustain growth and most of the notable FOBs have a shorter lifecycle than that of a privately-owned company. In Pakistan too, few of the famous families have managed to sustain their exalted standing in the business sector. Like everywhere else, in Pakistan too, family-owned businesses are often privately held companies whose shares are held by the members of the family and there are limits on transferability of the shares to an outsider. Therefore, in case of conflicts in a family, the company suffers extensively due to lack of focussed growth and sustainable strategy formulation on part of the directors. Most family businesses follow a similar path as they grow and mature. The first generation, typically known as founders, develops a set of values and ideologies that guide the people who inherit the family business and its management. Moving on, the practices are refined, evolving into professional policies and procedures. Since the next generation succeed the ancestors, they bring in new ideas of their age and being in key positions, guide the business into a period of greater growth and expansion. However, this inheritance structure can also serve as a last nail in the coffin where the family members who succeed their ancestors are sometimes not serious in the long term growth of the business or see the business as their entity where they can enjoy their power, thereby utilizing investors' money for their gains. Many businesses like National Foods, Ismail Industries, Rawalpindi Flour and General Mills Ltd. are just few of the very well established family businesses, from whom the following lessons can be learned.

(1) Initial emphasis by the first generation on governance principles

(2) Development of an organizational structure, human capital management policies and operation procedures by the succeeding generations

(3) Improved accountability and regulatory compliance

(4) Clear-cut identification of the roles and responsibilities for each family owner

(5) All directors/key position executives should be involved in strategy formulation and decision making.

(6) Trust-based relationships to allow for professional management and business growth.

(7) Early emphasis on building a team rather than handling single-handedly

According to a McKinsey & Co. Survey of 2002, only 15 percent of family-owned enterprises survive into the third generation (McKinsey & Company, 2002).

5. Why is Corporate Governance Critical for FOBs?

"Creating mechanisms like family constitutions and family councils can manage corporate governance apart from the family so the business does not suffer. Additionally good governance practices can assist in creating a more sustainable organization by delineating methods for generational transitions and succession planning" (Wang, et al., 2010).

The rapid and changing nature of the ways of doing businesses around the world with the globalization hype has brought many challenges for FOBs.

International investors often express their concern over the inadequate level of security for their investment, which creates reluctance to invest in emerging markets. According to McKinsey Survey, investors highlighted three main institutional areas where reforms need to be introduced and implemented religiously.

(1) Enforcement of legal rights, strengthened by the improved integrity of the judiciary and the legal system.

(2) Macro-economic stability supported by effective regulatory system.

(3) Accounting standards that prioritize the accuracy and timeliness of accounts.

6. Challenges Faced by FOBs and Recommendations to Address Them

Family businesses go through various stages of growth and development over time. These challenges are only discovered once the business has reached its second or third generation. A famous saying about family-owned business in Mexico goes "Father founder of the company, son rich, and grandson poor" which means the founder starts and builds a business, the son inherits and since he is not prepared to manage it, takes wrong decisions and simply enjoys the wealth, and the grandson consequently inherits a poor business and a dead bank account. Following are the challenges faced by FOBs:

(1) Centralized structure influenced by tradition

(2) Lack of long-term planning and sustainable growth strategies

(3) Appointment of ineligible and non-qualified family members

(4) Absence of standardized policies and procedures for insiders as well as outsiders

(5) Lack of expert outsider input

(6) Roles and responsibilities are not clearly defined

(7) Family problems affect the business

(8) Lack of knowledge and skills to find the worth of the business and the factors that make it valuable

Mentioned below are a set of guidelines for FOBs to overcome the challenges. Nevertheless, the key is adopting Corporate Governance systems:

Succession Planning: One of the greatest challenges to FOBs is the lack of succession planning. This process ensures the availability of competent family leadership across generations. Many analysts have identified the lack of succession planning as the most crucial reason for the early demise of these businesses (Bocatto E, 2006). In Pakistan, one of the principal sources of family disputes results from unsuccessful succession planning in relation to FOBs. There should be clearly defined eligibility rules including circumstances under which members of the family can take over the business, minimum education and experience requirement, clarity in the roles and responsibilities of each family member, performance evaluation using merit-based system, non-discriminatory compensation packages and equitable distribution of shares.

Independent Board and Sound Board Practices: The Board should be comprised of members who are able to contribute effectively to strategy formulation and sustainability of business. They should have competent experience, skills and specialized knowledge for the upward mobility of the business.

Separation of Ownership and Management: In FOBs the separation of ownership and management is a very complex activity which has been under debate since long. Since the owners of the company think that they are the ones who are supposed to make decisions, at times their personal wants and desires, family pressures, ulterior motives and lack of expertise affect their decisions, thereby adversely affecting the company's strategic objectives. Corporate Governance advocates that the ownership of the firm should be separated with the management, in terms of delegation of responsibility, solid organizational structure and clear reporting lines.

Functioning of the Board of Directors: The qualification and independence of Board members have a direct impact on a company's success (Mahomad J, Bulent S 2007). Therefore, the Board should be comprised of relevantly qualified and experienced directors who place the company's goals and objectives over theirs. Directors that are under the influence of the family will make decisions favoured by the family which at times, can be non-beneficial for the firm. Alternatively, independent directors will place the company's best interest over winning the favour of few powerful family members. It is also vital for the well-being of the firm that there is a continuous system of checks and controls are in place to foster accountability and governance. This will lead to prevention of conflict of interest between the board and the management. It is also imperative that there should be a significant ratio of independent board members. The CEO and Chairperson of the Board should be separate individuals. The number of board members should be no less than five and no more than 15 (Mahomad J, Bulent S 2007). Every board member should have a single voting authority and not the one that is based on the number of shares that member holds. This will contribute to impartial, performance-based decision-making. An annual review of the performance of the Board should be done, with re-election totally based on performance. Board members should have competitive compensation packages with some pay-out based on their performance. It is essential that the board members advocate a culture of transparency and the message they should pass to their sub-ordinate is the legal and appropriate disclosure of relevant information as well as adhering to regulations set out by SECP and SBP.

The SECP and SBP have been very active in introducing reforms in this area. PICG has a reputation to constantly educate directors by introducing programmes and seminars known as **Board Development Series (BDS)- Director Education Programme** which is a modular series of interactive workshops addressing the Chairmen, CEOs, Directors and Senior Management The BDS comprises 24 modules of two hours each, delivered in four parts with each part lasting two days, leading to certification. In recognition of the program's significance, the SECP and KSE (Karachi Stock Exchange) made it mandatory for all the directors of the listed companies to have certification under the BDS program offered by PICG (Pakistan Institute of Corporate Governance Website, 2012). The BDS program has been replaced by a new program Corporate Governance Leadership Skills (CGLS) based on the fact that Corporate Governance is crucial to the development of companies and the economy at large. The regulatory authorities, however, need to focus on FOBs and make it mandatory for family-owned firms as well.

Formation of a Family Council: One of the major reasons of business decay is family-split. Rivalry among the siblings can lead to severe consequences to the extent of splitting the business into pieces and dividing among the siblings. This can result in the loss of the competitive advantage and goodwill once enjoyed by the business, collectively. FOBs in Pakistan are increasingly recognising the role of a Family Council to manage and resolve existing and potential conflicts. The Family Council will constitute family members to oversee business activities and how the family should deal with business matters. A strong Family Council will help resolve issues and help the owners focus on other key issues. The Family Council can also formulate a constitution for the company describing family values, beliefs, Code of Conduct which helps maintain a strong bond among the family members and most importantly the role and responsibility of each family member.

7. Conclusion

For a family-owned company, good governance practices make all the difference. Family firms with effective governance policies, procedures and practices are more likely to carry out efficient strategic and succession planning. This results in quicker growth and longer business life. Family reputation can inspire the investors to direct their finances to the business. The FOBs in Pakistan provide evidence that these businesses can co-exist with the clever and more knowledgeable new generation entrepreneurs and trans-national companies, provided they implement Corporate Governance principles religiously.

References

[1] Abhouzaid S. (2007), *IFC Family Governance Handbook*, International Finance Corporation, pp 9-50.

[2] Bocatto E. (2006), "Family-owned Business Succession: The Influence of Pre-performance and the Nomination of Family and Non-Family Members: Evidence from Spanish Firms", Department of Economics de l'Empressa Jornada Conference. [On-line] Available at selene.uab.es/dep-economia-empresa/Jornadas/Programa_2006.html.

[3] CIMA Handbook Corporate Governance (2012), --- www.cima.org.uk , June 2012

[4] El-Din A. G. (2008), "Corporate Governance in Family owned businesses in Egypt: The Case of Egytrans, Cairo", Egyptians Institute of Directors' 4th Annual Conference

[5] La Porta R., Florencio Lopez-De-Silanes, Andrei Shleifer (1999), "Corporate Ownership around the World", *Journal of Finance*, 54(2): 471-517.

[6] Mahomad Jaffer & Syed Bulent (2007), Corporate Governance Issues in Family-Owned Enterprises, CIPE Economic Reform Feature Service. Accessed at www.cipe.org

[7] McKinsey & Company (2002), "Global Investor Opinion Survey: Key Findings", [On-line] Available at www.mckinsey.com

[8] P.I.C.G. (Pakistan Institute of Corporate Governance) (2008), "The Corporate Governance Guide--- Family-Owned Companies", A Practical Guide to Corporate Governance "Governance Challenges for Family owned Businesses", Chapter 5, pp. 121-144.

[9] Pakistan Institute of Corporate Governance (2012), Accessed on: www.picg.org.pk (June 2012).

[10] Wang Z. J., Gulzar M. A., (2010), "Corporate Governance and Non-Listed Family Owned Businesses: An Evidence from Pakistan", International Journal of Innovation, Management and Technology, Vol.1, No.2, pp124-129.