INTERNALIZING CORPORATE GOVERNANCE PRINCIPLES IN FAMILY BUSINESSES

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The past economic crises have served as a constant reminder that the observance of modern corporate governance principles continues to be a clear reflection of corporate commitment to responsible citizenship. Both draw inspiration from the fundamental principles of fairness, transparency and accountability. This is particularly true for family businesses (FBs) that have increasingly played a critical role in the development of national economy and the community as a whole.

In the past, FBs were often the ones to blame as the culprits behind economic crises. The great business historian Alfred D. Chandler has blamed the economic decline of Great Britain, for instance, partly on FBs – on their lack of scale, backwardness, and inability to preserve capital. This view unfortunately still dominates until recently. Many still think negatively about the disadvantages of FBs: corruption, nepotism, governance conundrums and favoritism towards family members.

But series of the recent crises undoubtedly also showed us that these disadvantages are not necessarily only the monopoly of FBs. Once touted non-family firms like Enron, WorldCom, Barings, Lehman Brothers, and even old standards like GE and Time Warner were partly to blame for the stock market crash of 2001 to 2008. Greedy top executives of these companies whose stock-priced-based compensation supposedly heightened accountability have contributed to the problems as they gamed the system, focusing too narrowly on massaging the numbers to earn their bonuses instead of building up core competencies and delivering value, emphasizing so much on achieving corporate financial objectives rather than mission as responsible corporate citizens.

Be they caused by family firms or non-family firms, most of economic crises in the past decades eventually boil down on bad corporate governance practices. While the principles of, and the culture behind, corporate governance are fundamentally the same everywhere, the practices and approaches to improving those practices do vary from one country to another, as well as between family firms and non-family firms.

Principles, Structures, and Rules in Family Business

Four major categories of principles, structures, and rules are evident in an evolving family business. That is, the family business as a community of people; committed business families; power as a service; and estate transfer as a responsibility. Successful development of these areas bodes well for the longevity of the business, and exploring these categories in greater depth gives a better-rounded picture [1] of what being a committed business family entails .

First, the fact that the FB is a community of people suggests that financial success is not the only requirement for survival. A family business “includes owners, managers and people who work within it, and these people must be organized in accordance with the proper formal structures of responsibilities and management systems.” Families must set up membership rules, commit themselves to the development of members’ professional skills, compensate their members fairly according to a transparent and logical structure, and “meet the ‘social mortgage’ attached to any kind of ownership.”

1 Miguel Ángel Gallo, Daniela Montemerlo, Josep Tàpies, Kristin Cappuyns, Salvatore Tomaselli, Sabine Klein (IESE Business School), “Five Secrets Behind Successful Family Businesses,” 2006.

Second, for family members to be united and committed to the business, there must be a structure in the form of “a combination of values, principle systems and rules.” In fact, the values that lie at the heart of these structures are to some degree an attempt by the owner family to formalize some of its beliefs with a view to establishing a long-lasting FB.

Third, the idea of power as a service means that the decision makers in a family business must “demonstrate high-quality motivational balance, since their decisions must take account of transcendent motives and not just intrinsic and extrinsic arguments.” There are two types of power: potestas, which is “the power to decide that is afforded by law,” and auctoritas, which is “the power to decide that is afforded by the possession of the required professional competence.” The different powers exercised by owners and shareholders must be balanced an important challenge that’s vital to the formation of an FB.

Finally, the idea of estate transfer as a responsibility means that plans must be made for the transfer of “ethical, human, intellectual, financial and other resources.” The future of the business must be of utmost importance when making transference decisions, and “the common good takes precedence over the personal good.” Tyranny must be avoided by selecting “good and decent beneficiaries who intend to organize governance in a collegiate way.”

Committing to an FB brings a great deal of responsibility, and when people make this commitment, they may feel a certain degree of ownership over that business even when they are not, in fact, the owners – a phenomenon called “psychological ownership.” This can negatively affect the unity of the group. However, in multi-generational family companies, this feeling can also be positive: feeling ownership “generates commitment, a desire to make an effort to give something back to the family and the business, because so much of what an individual possess has been received from them.”

This kind of intense commitment and involvement is what business families must strive for in order to survive through multiple generations. Instead, given the ever changing cycles of people’s life’s, as well as the changing circumstances in the family business, no perfect solution can ever be found. Companies are constantly evolving and family members must continually renew their commitment to the business. By understanding what drives people’s behavior, and by analyzing the characteristics of successful multigenerational FBs, business families can begin to strengthen and become, one day, committed business families with a business that will stay viable even when they themselves are gone.

Family Business vs. Non-Family Business

There are a number of persistent myths about FBs in Asia. One such myth is that FBs are small and cannot grow beyond a certain size. The term family business often evokes images of a food stall run by a hard-working husband-and-wife team.

Moreover, family businesses, seemingly, had skirted most aspects of modern management practice. Far from acting accountable, the CEOs who were usually the founder/owner were often secretive. They disliked explaining themselves to shareholders or even opening their books to their bankers. They resented being questioned and sought enormous discretion to do what they believed was right for the company – which was, they insisted, “their business.” Many took only a passing interest in quarterly financial statements, and just as many mistrusted the numbers. Family business leaders then used their freedom to stubbornly ignore market trends or to make moves that were radically out of step with what the rest of industry was doing.

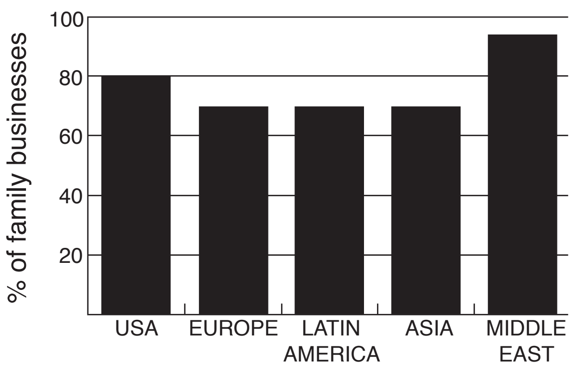
When it came to strategy, family firms lived as much in the past as the future. Some traditions were sacrosanct, and fulfilling a family mission was almost always more important than any bottom line – in fact it was the bottom line. Relationships with outsiders seemed “crony-like,” with contracts based on personal attachments rather than competitive bargaining. What century were these companies living in, we wondered? Who are these guys?

But, the fact remains that a substantial share of the largest firms particularly in Asia is FBs. Though often overlooked due to their discretion and quest for privacy, FBs form the bedrock of most economies. In fact, family-owned firms constitute a major proportion of businesses in most developed economies all over the world, dominating the private sector and stock exchanges in many emerging markets. The driving force behind much of the economic success in many parts of the world has been the FBs, and this is particularly true in Asia.

In Asia, family firms are even more prominent, especially among the larger firms. Many of the Asian family firms have evolved into conglomerates that consist of a large number of separate firms, several of which may be listed on stock exchanges in the region. A number of studies show that Asian FBs listed on stock markets in the region have generally outperformed their non-family peers in most Asian markets[2].

Family businesses make up 35 to 40 percent of the Fortune 500 and S&P 500. They generate at least 50% of the GDP and account for over half the employment in the United States and 78 percent of the new jobs[3] created . Comparable figures for Asia, Europe, and South America are significantly higher.

FAMILY BUSINESSES AROUND THE WORLD



On a more global level, according to the Family Firm Institute, FBs create an estimated 70% to 90% of global GDP annually[4]. The preponderance of FBs in the world's economic landscape is undeniable – typically, FBs enjoy certain competitive advantages that their non-family corporate counterparts do not – not just stable ones like efficiency and quality, but innovation, brand building, and entrepreneurship.

Family businesses are also more inclined to put greater importance on long-term success and strategy, otherwise known as 'patient capital'[5]; they have the opportunity to create a legacy which creates a strong sense of pride among their employees as well as brand recognition in the market; and they also have an easier access to capital for new business initiatives. They sustained their advantages as markets and technologies altered and the rosters of rivals churned. They showed an amazing consistency in their practices. They had embraced a peculiar pattern, stuck with it, and got away with it – time and again.

Time and time again, FBs have been shown in many studies to outperform publicly-listed non-family businesses. This is true in revenue growth, market valuations, return on assets, return on equity, and total shareholder returns. Do they accomplish that performance by running down their resources or taking excessive risks? The research evidence suggests not. FBs seem to invest more than non-FBs in human resources and training, in social benefits for their people, and in modernizing plant and equipment. They also enjoy better cash positions, more stable earnings, and lower debt to equity[6].

Family Business Regeneration

Maintaining the delicate balance among members

2 Credit Suisse (2011) Asian Family Businesses Report 2011, Emerging Market Research Institute, Credit Suisse.

3 The Canadian Inheritance Study, DecimaResearch, 2006, Boston College Social Welfare Research Institute, January 2003

4 http://www.ffi.org/?page=GlobalDataPoints

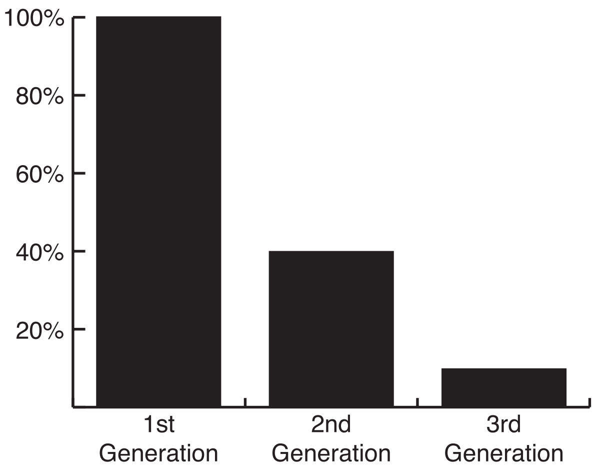
5 KPMG Enterprise 'The Competitive Advantage of a Family Business' (http://www.kpmg.com/Ca/en/services/KPMG--Enterprise/Centre--for--Family--Business/Documents/Competitive%20Advantage.pdf)

6 Vikas Mehrotra, Randall Morck (University of Alberta in Edmonton, Canada), Jungwook Shim, Yupana Wiwattanakantang (Hitotsubashi University in Tokyo, Japan), "Adoptive Expectations: Rising Son Tournaments in Japanese Family Firms."

of a family business is not always easy; people have different personalities and goals that can complicate their interactions. However, maintaining a high level of family functioning is crucial for a business's long-term survival. Though founders may be fully committed to the business, passing that commitment on to subsequent generations can prove challenging – even impossible[7].

Only about 30% of FBs survive into the second generation, 12% are still viable into the third generation, and only about 3% of all FBs manage to thrive into the fourth generation or beyond. Thus, goes the sayings: in Brazilian "Pai Rico, Filho Nobre, Neto Pobre" (rich father, noble son, poor grandson), in Mexican "Padre Bodeguero, Hijo Caballero, Nieto Pordieroso" (father merchant, son gentleman, grandson beggar), and in Chinese "Fu Bu Guo San Dai" (wealth never survives three generations). In fact, many FBs do not survive beyond the second generation. A failure to develop the founder's business, together with disputes over dividing up the spoils, is usually instrumental in the demise of family firms.

WEALTH RETENTION IN FAMILIES



In spite of the benefits of FBs, their success is anything but guaranteed: only 10% of FBs continue to a third generation.

Though a business's founders may start with strong "potential motivation" to improve their own and their families' lives, turning such motivation into "current motivation" is difficult, for two main reasons. First, when founders prepare to leave the business, they may resist transferring the business to the next generation or changing strategy or organization. Second, subsequent generations may choose not to be involved, and founders may opt to sell the business to ensure family members' financial security. Yet, many multigenerational FBs thrive – and "the key lies in the qualities of the people who form the ownership group."

REASONS FOR FAILURE

60% OF THE CASES WAS DUE TO A LACK OF COMMUNICATION.

30% OF THE CASES WAS DUE TO A LACK OF EDUCATION OF THE NEXT GENERATION.

3% OF THE CASES WAS DUE TO POOR INVESTMENT DECISIONS.

As many of Asia's FBs are still owned by their first or second generation of the founding family, one of the biggest issues facing these firms is that of regeneration. With the retirement of the founder, regeneration often involves a change in both shareholding and management. There is a tendency for most families to eventually bring in non-family CEOs and Chairmen. But these are often not endowed with the same powers that the founder had – due to either fragmented shareholdings or the presence of the founder who still has the loyalty of the employees.

Smooth regeneration and smooth transition of shareholding and management in FBs also depends on the degree of professionalism in the succeeding generations. Professionalization in FBs not only means bringing in professional non-family members to work in FBs, but also professionalizing their own family members. This is often times influenced by the level of their education.

7 Miguel A. Gallo, Sabine Klein, Daniela Montemerlo, Josep Tàpies, Salvatore Tomaselli, and Kristin Cappuyns, "From the Founder to Multigenerational Family Business: The Family's Crucial Role as an Owner for Longevity."

Highly educated future FBs leaders will be crucial to maintain growth and development of Indonesian FBs. However, as a growing economy with a young population, meeting the demand for higher education will be a major challenge for Indonesia in the coming years. A report from the Boston Consulting Group in May 2013 stated that by the year 2020, Indonesian companies, including FBs, will have difficulties in filling half of their entry-level positions with qualified candidates.

The current low enrollment rates in tertiary education in Indonesia are part of the reason. Data shows that enrolment rates in higher education and in secondary schools in Indonesia are only 13.28 percent and 51.35 percent respectively, compared to a Southeast Asian average of 27.40 percent for higher education enrolment and 65.20 percent for secondary education enrolment."

The requirements of leadership in Indonesia are really intense, because many family businesses start to look for leaders who can take organizations and really very rapidly advance them and adjust to changes in their own environments. The availability of managerial skill in Indonesia does not come close to matching the needs, as a result of this growth.

Family Business Governance in Indonesia

Family businesses are one of the foundations of the business community. Their creation, growth and longevity are critical to the success of the national and global economy. In Indonesia, more than 90% of businesses are family-owned and controlled companies. Although facing many of the same day-to-day management issues as publicly-listed non-FBs, they must also manage many issues specific to their status.

Many of these issues in family business are actually also issues that many ordinary citizens are facing in their day-to-day family life. Thus, there is a close inter-relationship between how a family nurtures and lives its values and how a family-owned company shapes and lives its corporate culture.

Family members come and go, companies on the other hand are built to last for many generations to come. It is very crucial, therefore, that these companies are built upon a solid foundation that is laid and created by the first generation of the families.

It is the first generations that actually set the tone at the top for the future and sustainability of many successful FBs. They can do this by creating a "Family Constitution or Charter" where the path of good corporate governance and family business principles crosses at each other and a clear guideline on how the family and business matters are treated is drawn.

Family businesses have to strive to be as well-managed as the best of their competitors. The need for a professional business approach is in fact greater in a family than in a non-family company. Family businesses have also distinctive characteristics from which they can derive significant competitive advantage as described above. A long-term perspective comes from building a business for future generations while the strength of most FBs' founding values give them a clear identity in an increasingly faceless corporate world.

But there are also risks associated with this type of company, most notably the dissension that may arise within families, particularly between family members who are actively working in the business vs. those who are solely shareholders.

Thus, four key issues related to FB corporate governance need to be highlighted: (1) recruitment system that allows willing family members to be employed should be balanced with a performance-based promotion that is resolutely the same for both family and non-family managers; (2) fairness and transparency in financial and non-financial perks and reward systems, particularly within the family, to avoid tensions over perceived injustices; (3) more formal organizational structures to clarify roles and to separate the day-to-day management from the strategic direction of the business; and (4) a regular and proper channel of communication among family members to keep the integrity and unity of the family.

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