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EVOLVING CORPORATE GOVERNANCE CHALLENGES OVER A FIRM'S LIFE CYCLE

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There are two commonly cited findings about family businesses that highlight the pitfalls and potential of such businesses. First, most family businesses have a short life span beyond the founder's stage and it has been estimated that 95 per cent of family businesses do not survive the third generation of ownership. Second, family businesses (those that do survive) tend to outperform non-family businesses. In other words, they either die young or they thrive.

Family businesses need to pay attention to both family governance and business governance issues in order to survive and thrive. As a business founded by a family evolves, it will face different governance challenges that pose both opportunities for its continued growth and threats that may cause its demise.

In this article, I discuss the key corporate governance challenges faced by the following types of businesses:

Family-managed private company; family-controlled professionally managed private company; family-controlled public company; jointly-controlled public company; and public company with dispersed ownership.

Family-managed private company

During this stage, most of the challenges faced by a family business are likely to be internal. It is not tapping outside capital, except perhaps for bank loans, and therefore does not have to deal with complicated relationships with outside investors.

The success of family businesses often has to do with the commitment, knowledge continuity, and the importance placed on preserving the family reputation and family pride. These give it an advantage over other forms of business. However, family businesses may also suffer from the lack of preparation of the subsequent generations to handle the demands of a growing business and a much larger family. As a family business grows, it needs to pay attention to both family governance and business governance issues.
A 2013 survey by KPMG Singapore identified the following five major causes of conflict within a family business: competence of family members working in the business; future strategy of the business; lack of family member communication; remuneration; and succession.

Ernesto Posta's Family Governance: How Leading Families Manage The Challenges of Wealth published by Credit Suisse Group AG in 2012 and the IFC Family Governance Handbook published in 2008, have identified a number of challenges of family businesses: loss of family identity and values; family conflicts; current leader's inability to let go; an entitlement culture; dilution of wealth (due to personal consumption and breakup of business interests); informality (lack of clear business practices and policies and procedures); lack of discipline (such as lack of succession planning); lack of transparency; and lack of oversight/self-dealing.

Conflicts in a family business tend to increase as it moves through generations because different members of the extended family may be involved in different capacities as shareholders, directors, executives or employees. Some may be shareholders relying on dividends while others may be executives or employees drawing salaries, and therefore, criteria for employment in the business and the setting of remuneration become important.

As a family business grows, having proper family governance becomes increasingly important. Family governance mechanisms such as a family constitution (which sets out the family vision, mission, values, and policies regulating family members' relationship with the business), family meetings, family assembly or forum, family office and family council may become necessary.

Failure to properly plan for succession is a common failing of family businesses. This often happens because of family members delaying the decision in order not to create potential friction among family members or because no current family member or outsider is deemed capable of replacing the current CEO; avoiding awkward discussions of the eventual loss of a family leader (the current CEO); and the current CEO refusing to admit that the company can survive without him or her and who is afraid of retirement.

In terms of business governance, some of the challenges faced by early-stage family businesses are similar to those faced by small and medium enterprises (SMEs) generally. Being relatively small and more informally managed, they suffer greater exposure to risks such as fraud risk. Good corporate governance and sound internal control and risk management are often seen as business costs and merely good to have. Therefore, they may pay insufficient attention to issues such basic internal controls and internal audit.

According to the biennial global reports on occupational fraud and abuse published by the Association of Certified Fraud Examiners, the most common organisational victims of fraud are private companies and small companies (which include many family businesses). In 2014, 38 per cent of victims of fraud are private companies and 29 per cent are small companies with fewer than 100 employees. Of course, such companies also make up by far the largest number of organisations. What is more interesting, however, is that the median loss from fraud in dollar terms for private companies and small companies are generally no smaller, and often larger, than for public companies. For small businesses, such fraud risks can have business-ending consequences.

I asked the managing partner of a mid-tier accounting firm that has many SME clients for a list of the most common internal control deficiencies in SMEs. Many of these deficiencies are what we would call Internal Control 101 stuff, such as improper access rights; lack of credit limits and credit terms not in place; unauthorised credit adjustments to customers' accounts; invoices not sufficiently supported with documents; petty cash system not properly maintained leading to excessive cash kept in the office; staff claims not sufficiently supported with documented evidence; payments via cash instead of cheques and bank transfer to vendors' accounts; three-way matching not performed prior to making payments; double payments made for the same invoice number; and discrepancies in salary amounts between employment contract and payroll details.

Family-controlled professionally managed companies

Some family businesses remain largely family managed as they grow because they continue to have qualified family members who are interested in the business. For others, the family may retain ownership control but engage professional managers. Some family businesses that do not yet have family members suitable to run the business may bring in professional managers as a transition, and part of the role of the professional managers is to help prepare family members for future senior management roles.

Family businesses can certainly benefit from hiring professional managers but need to address certain governance challenges. They include how to preserve the family/founder values; treatment of family members versus professional managers; "agency" problem of divergence of interest between the family owners and professional managers; and mechanisms to put in place to foster performance and commitment of professional managers while preserving the family/founder values.

Those who have watched Christopher Nolan's Batman Begins may recall the poignant scene of a young Bruce Wayne travelling into the city with

his dad, Thomas Wayne, on a train built by Wayne Enterprises, on that fateful night when Bruce's parents were murdered. As the train passes the Wayne Enterprises building in the distance, Bruce asked his father: "Is that where you work?" His father, a doctor, replied: "No, I work at the hospital. I leave the running of our company to much better men." Bruce asked: "Better?" His father then added: "Well . . . more interested men."

In the course of the Batman trilogy, we can see that these "more interested men" – who were professional managers – took the company on a very different path. It started making all sorts of weapons purely for the sake of profits, which was clearly at odds with the values of the founder-owner.

Professional managers may be motivated but may not share the same values as the owners.

Some family-controlled private companies, whether managed by family members or professional managers, appoint independent directors to benefit from a greater range of expertise and perspectives.

Family/owner-controlled public companies

As a family business evolves and grows, the family owners may decide that it is time to go public and get listed. Some do so to divest part of their ownership, others to improve the image of the business, but the most important reason to go public is when the business truly needs additional external capital to grow and public capital markets are the preferred means. It is not a decision that should be casually taken because a public listing comes with great responsibilities and expectations from public shareholders, regulators and other stakeholders. When a business becomes public, the owners are no longer just owners – they are also stewards of other people's money.

Corporate governance issues that become especially important at this stage include adequate separation among the roles of owners, directors and senior management; having suitably qualified and truly independent directors; a robust internal audit function; high quality financial reporting and external audits; proper disclosure and governance of related party transactions; and equitable treatment and regard for the rights of minority shareholders.

The problem with many family businesses that become public is that they fail to shed legacies and mindsets that are no longer appropriate for a publicly listed company. For example, a founder of a venture capital firm in Singapore has this to say about SMEs, which apply to many family-controlled listed companies: "More often than not . . . SMEs see the board as a regulatory conformance and overlook the fact that the board should play a key role in the firms' performance . . . With the lack of resources being a common issue for SMEs, SMEs are usually heavily dependent on the vision, capabilities and network of their founders. This dependence, if not managed properly, can potentially limit the growth of a company. At the same time, if the company wants to expand its business outside of (the country), it will have to manage a whole new set of challenges that it may not be equipped to handle. In my opinion, it is at this stage of growth where SMEs can benefit from having a strong board. As the business grows, an owner-manager needs to be aware of the immense benefits that an NED (non-executive director) can bring to the company and consider bringing one or more NEDs on board to take the business forward."

Some years ago, I spoke to the Asia CEO of a large multinational, who was an independent director in a listed subsidiary within a group that was controlled by a founder. The founder was a brilliant entrepreneur, but did not have the financial and management skills necessary as the business grew, was not open to different views, and continued to exert control over all key decisions. This highly successful executive had resigned as a director and predicted at the time that the group would eventually collapse. Fast forward a few years and the company is going through restructuring to avoid bankruptcy. The company had grown too fast – diversifying into other sectors and markets – and taken on too much debt. During that meeting, we talked about this scenario being repeated over and over again – and how this is preventing many family businesses from becoming global businesses.

In a study that I did some years ago with a first class NUS BBA (Accountancy) Honours student, we found that many listed family companies in Singapore have independent directors who only serve on one board – the board of the family company. These directors are not sought by other companies – we inferred that they are invited to serve as "independent directors" because they are family friends. Others make another mistake – they recruit what we might call "the usual suspects" – those who sit on many boards but who may not necessarily have the commitment or the right competencies.

In another study of Singapore listed companies, I found that it is not uncommon for these listed companies – often family businesses – to have directors who are over 70 years of age and who have served for a long time. Often, there are several of such directors. I have no bias against older directors but would caution that while many companies are facing disruption, boards often remain static.

It is understandable for a family owner to want to retain control, but they must remember that it is not just their company anymore. Therefore, while they are perfectly entitled and it is often desirable for them to have themselves or their nominees on the board, it is also important that the board is allowed to do its job without over-interference from the owners. The board needs to effectively transition from one that may heretofore be involved in management, to one whose role is more setting the general direction, oversight and providing guidance to management.

It would be almost unfathomable for any publicly listed company not to have a robust internal audit function in place. Unfortunately, many listed SMEs today have internal audit functions that are of doubtful value. Some are essentially "one-person" in-house outfits with the internal auditor lacking the necessary training and experience. For SMEs, outsourcing the internal audit function may make a lot of sense because it is often too expensive to maintain an in-house function that has the breadth and depth of experience necessary to implement a robust internal audit programme and retention of key internal audit talent may be a challenge. However, when outsourcing, they need to ensure that the service provider is capable of supporting the needs of the business.

A few years ago, I led a group of NUS students in a governance review of a listed SME. It was not a family business, but it was owner-managed in the sense that the CEO (who was also the chairman) owned nearly a quarter of the firm.

It had outsourced its internal audit to a very small service provider. The SME started in Singapore but had branched into Malaysia, Indonesia and Thailand. It had grown beyond what we thought the service provider was able to support. We recommended that the company review its internal audit arrangements and consider sourcing for a service provider with the regional footprint to support it, and the company subsequently replaced its internal auditor.

Being a publicly listed company, having high quality financial reporting and a robust external audit become especially important for building and maintaining investor confidence. For such "public interest" entities, financial reports and audits of public-listed companies are also subject to greater regulatory scrutiny.

Family-controlled listed companies need to be especially watchful about related party transactions that benefit the family at the expense of public shareholders. Stock exchanges, therefore, not surprisingly often put in strict rules around such transactions.

They also should not under-estimate the importance of equitable treatment of minority shareholders and respecting their rights. Today, there are more minority shareholders who are willing to question the actions of the board and management in shareholder meetings, the media and online forums. They may not be able to significantly influence the decisions of the board and management, but they can certainly cause embarrassment and investors to lose confidence in the company. Some may hold enough shares to call meetings and propose resolutions to get the board's and management's attention. Where a company counts institutional investors and fund managers among their investor base, these investors may also expect to be able to have private meetings with the board and management.

Jointly-controlled public companies

Not all family or owner-controlled businesses stay that way after they become public. Some of these businesses end up with other major shareholders in addition to the family or founders. Each major shareholder may have its own representative on the board. There are pros and cons with companies having multiple large shareholders. If they share common values and vision, then such an ownership structure may be sustainable. It can also lead to better corporate governance through better mutual checks and balances among the major shareholders.

The earlier mentioned SME was an example where having multiple substantial shareholders each represented on the board has worked out well. In the course of the governance review, I asked the CEO whether the fact that he was also the chairman and a large shareholder meant that he had too much power. He pointed out that the other two large shareholders on the board together own as much of the company as he does, and they provide a check and balance on him. But there are also examples of companies with multiple substantial shareholders torn apart by differences among the shareholders and shareholder disputes. It is important to have the right partners who share the founder's vision, but the founder also needs to be open to the viewpoints of others who also have significant investment in the business.

Public companies with dispersed ownership

As the need for public capital continues to grow, the ownership of the family or founder may be diluted to such an extent that it becomes a minority shareholder, just like everybody else – or the family or founder may even have sold out completely. Companies without one or more major shareholders are common in countries such as in the United States and United Kingdom but relatively rare in many other parts of the world.

Some view dispersed ownership as corporate governance nirvana because there is no dominant controlling shareholder who essentially calls the shots but it is not necessarily the case that corporate governance will be better. The corporate governance challenges just tend to be different ones. With dispersed ownership, the key corporate governance issues revolve around the lack of accountability and oversight, with no one with enough of a stake to make the board and management accountable. In this situation, there is often reduced accountability of the board to shareholders and reduced oversight of management by the board. The result is often dominant management and excessive management remuneration. As this kind of ownership structure is common in US public companies, it also helps explain why these are common corporate governance issues in companies there.

It has often been said that corporate governance is a journey and that is true in a number of ways. There is always room for improvement. The issues faced as the business evolves also change. It is important that families and business owners understand the most pertinent issues they have to address at different stages of their business life cycle – which hopefully will be a very long one.

This article is a revised version of the article titled "Navigating corporate governance challenges over a firm's life cycle" first published in Business Times in Singapore on 29 March 2016.