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Corporate Governance and Non-Listed Family Owned Businesses: An Evidence from Pakistan

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Abstract—**Family owned businesses are the backbone of many economies around the world. Increasing growth and globalization has brought many challenges for family businesses. The way you deal with them can mean the difference between success and failure. By adopting sound corporate governance systems, many of these challenges can be tackled. In this paper, we describe the importance of corporate governance in family owned business. This study examines the theoretical background of corporate governance in family businesses in Pakistan. Introducing the concept of good corporate governance is vital for the continuity and sustainability of the family owned businesses that support economic growth. In addition to board of directors, more non-executive and independent directors, board committees, bylaws and company codes should be introduce in a company. Corporate governance will ensure that FOBs are transparent enough to satisfy various stakeholders such as suppliers, customers, and creditors.**

Index Terms—**Board of directors, corporate governance, family owned businesses (FOBs), Pakistan**

I. Introduction

For over a decade, international attention has focused on corporate governance practices in family owned business. Family owned businesses face many challenges for their sustainability and profitability. Corporate governance measures at the family and business levels provide good solutions to family ownership challenges and often are indispensable to the long-term success of the family business and peace in the controlling family, especially with succeeding generations.

Family-owned companies are characterized as organizations in which the shareholders belong to the same family and participate substantially in the management, direction, and operation of the company [12]. "A family business refers to a company where the voting majority is in the hands of the cont--rolling family; including the founder(s) who intend to pass the business on to their descendants"[15]. Family firms are companies in which one or 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 [5].

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Each family has its own unique ethics, values, histories, unwritten rules and communication methods. As the family structure shrinks or expands, the company changes, particularly with the start of the second and third generations. Changes instigated by new generations can improve or harm the business. A recent survey suggests that 85% of the FOBs are completely vanished before the fourth generation [12].

According to Sir Cadbury, corporate governance is "the system by which companies are directed and controlled" [4]. Generally, it refers to the processes, structures, policies and laws that govern the management of a company. It also refers to the way the Board oversees the operations of a company and about how board members are accountable to the company and its shareholders.

In recent years, the debate on corporate governance has reached high visibility at the theoretical, managerial, and political levels. This has prompted some scholars to argue that the paths of economic development and competition are based on the quality of the corporate governance rules [9], [14]. The key purpose of corporate governance is to promote accountability, transparency, fairness, disclosure and responsibility - core values that are relevant to the success of all businesses, irrespective of where they come from. Some other definitions of corporate governance are shown in table 1.

Table 1. Suggested Definition of Corporate Governance

Rules	Family values and culture
	Business values and culture
	Operation systems
Structures	Assembly board of directors, executive board
	President, CEO and COO
Individuals	owners
	Family managers
	Non-family managers
	Other individuals who bring to valuable interests to the business
Activities and processes	To manage the organization
	To control management decisions
	To be responsible for the activities towards family and non-family stakeholders (accountability|)

Family owned businesses, FOBs, are the backbone of many economies around the world. FOBs are the predominant form of enterprise around the world and many of the world's most famous large corporations of today have started as FOBs [3]. Examples include Acer Computers, Wal-Mart, Ford Motor Company, Matthew Algie, Mills Fleet Farm, SC Johnson Company, Tetra Pak, William Grant & Sons, Vanee Foods Company, Anheuser-Busch, DuPont, Kosh Industries, Cadbury…etc. Moreover, family ownership of listed companies is a common feature of domestic capital markets in Asia, Latin America, and Europe. Many studies indicate that FOBs contributes largely in the economic wealth creation in most country's economies. The most conservative estimates between 65% and 80% have increased the proportion of all worldwide business enterprises that are owned or managed by families [6]. However, U.S. accounts for 80 to 90 percent of the 18-million business enterprises, and 50 percent of the employment and GNP. In Canada, this figure is higher, i.e. 80% of the companies listed on the Toronto Stock Exchange closely held in family trusts or the founders hands [11]. In Europe, family firms dominates small and medium size firms which are in majority than larger firms in some countries [6]. In Singapore and Hong Kong, the numbers are similar as many of the local business enterprises (e.g., business enterprises started by overseas Chinese entrepreneurs in the post-war period 40 years ago), have recently gone public. In Taiwan the small and medium-sized family enterprise accounts for more than 98.5% of companies, 80% of employment and 47% of the total economy [11]. It is estimated that 40% of the Fortune 500 are family owned or controlled [6]. Large FOBs (both listed and privately held) play a major role in OECD (Organization for Economic Co-operation and Development) economies. Family-run businesses account for more than 85% of all firms in OECD countries [10]. Moreover, FOBs dominate many developing economies as well as figure prominently in certain developed economies. In India, and during the 1970s, 93% of privately owned companies were FOBs [13]. Sir Cadbury (2000) has also concluded that FOBs are one of the foundations of the world's business-125-community [2]. FOBs employ between 50-60% of the companies around the world which represents 95% of the companies in Gulf area, which are forming 70% economy of the Arab region [1] FOBs represents at least 55% of the GNP of any Arab country, 95% of all listed companies in the region and employ 70% of the jobs outside of the government and public sector in the region [8]. The local investments of 20 thousand FOBs in the Gulf area alone exceed $500 US Billion while their total international investments worth over $2 US Trillion [1]. In the Kingdom of Saudi Arabia, 95% of all companies are FOBs, investing around $70 US billion or 24% of the country's GDP in 2006 [8].

Family-owned companies are characterized as organizations in which the shareholders belong to the same family and participate substantially in the management, direction, and operation of the company [12]. "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 the business on to their descendants"[15]. Each family has its own unique ethics, values, histories, unwritten rules and communication methods. As the family structure shrinks or expands, the company changes, particularly with the start of the second and third generations. Changes instigated by new generations can improve or harm the business. A recent survey suggests that 85% of the FOBs are completely vanished before the fourth generation [12].

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 [12].

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

Family-owned companies are characterized as organizations in which the shareholders belong to the same family and participate substantially in the management, direction, and operation of the company. It is widely recognized that each family has its own unique unwritten rules, values, histories, and communication methods. As the family structure shrinks or expands, the company changes, particularly with the advent of the second and third generations. Changes instigated by new generations can improve or harm the business. A recent survey suggests that only 15% of family-owned enterprises continue to survive to the third generation. Of those that do last, 85% either disintegrate or completely vanish before the fourth generation takes the reins.

Families have a number of unique attributes that serve to strengthen a family business, including love, care, unconditional acceptance, generational hierarchy, emotion, informality, closeness, loyalty, commitment, stability, relationships, growth and development, safety, support, and tradition. Families can also have a number of negative traits such as anger, tension, confusion, competitiveness, and strangled communication, which can affect a company to the detriment of all. These qualities are reflected into business ownership methods and styles, and can support or harm a company. Good governance mechanisms can alleviate some of the problems that arise when family characteristics become a driving force behind company action.

This research aims to present the importance of corporate governance in family owned businesses in Pakistan. This paper will contribute both academic as well as practical knowledge about the importance of corporate governance in FOBs by exploring reasons, process and challenges facing FOBs. This study also recommends sound corporate governance practices for the FOBs to increase its profitability and sustainability. In this paper, first part is the introduction. Second part discusses the family own business in Pakistan. Third part highlights the pros and cons of FOBs. Fourth part is about major challenges face by FOBs. Fifth part will discuss why corporate governance is crucial for FOBs and how can FOBs adopt sound governance practices. The last part is the conclusion.

II. Family Owned Business (FOBs) in Pakistan

Pakistan has been experiencing phenomenal economic growth in the past few years, leading to a sizeable increase in the number of unlisted companies, particularly family-owned organizations. The Securities & Exchange Commission of Pakistan has recently reported that the total number of non-listed companies has now surpassed the 50,000 mark, in counterpoint to the 5,000 or so companies registered.

Despite having a close network of owner/directors and the ability to make decisions quickly, family-owned companies are generally unable to sustain growth and have a shorter lifecycle than a privately owned company. In Pakistan, amongst the so-called 22 families identified in the Ayub Era, only a few have managed to retain their prestigious position [12]. The principles of good corporate governance are as useful for non-listed companies as for listed companies. In countries like Pakistan, where a corporate governance code has been established for listed companies, these principles can be practiced by family-owned and non-listed companies as well. Some countries – including Egypt, Turkey, Belgium, and Finland –have also developed indigenous, voluntary corporate governance guides for non-listed, family-owned companies.

In Pakistan, family-owned companies are often private limited companies. Shares are held by a small group of people and there are limits on transferability. When this small group of people, however, is a family in conflict, the company suffers from a lack of objective analysis on the part of independent directors.

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.

Family-owned, listed companies are the backbone of Pakistan’s economy. However, these companies are traditionally either unaware of the general principals of good corporate governance, or work in a relatively less open environment. Promoting basic principles of good governance for family-owned companies is crucial in supporting the development of a strong economic sector. The sharp growth in such companies is fueling the growth of Pakistan’s private sector, making good governance even more important for businesses. Currently, the Code of Corporate Governance only ensures compliance for companies listed on the stock exchanges. Introducing the concept of good corporate governance is vital for the continuity and sustainability of the unlisted companies that support economic growth in Pakistan.

III. Pros and Cons of FOBs

The family business is the world’s most common type of business organization. It is also the most complex, with unique strengths and weaknesses that stem from being family owned and managed. On the positive side, family businesses tend to emphasize high quality, invest for the long term and develop loyal relationships with employees and key stakeholders. This can make them tough competitors. At the same time, family businesses also tend to focus on issues and tensions within the family. A heightened concern with control can limit their growth and opportunity. “Family Business Consulting” summarizes the key FOB strengths & weaknesses in the following table 2:

	Strength	**Weakness**
Infrastructure	Informal; flexible; entrepreneurial; innovative	Unclear; confusing; boundary problems; indecisive; resistant to change; lack of management development; no organization charts
Roles	Often play multiple roles; flexible; dual relationships; quick decision making	Role confusion; jobs don't get done; nepotism; dual roles interfere with learning and objectivity; family birth right can lead to unqualified family members in jobs
Leadership	Creative; ambitious; informal authority; entrepreneurial	Autocratic; resistant to structure and systems; avoids letting go
Family's Involvement	Employees committed; loyal; shared values and belief system; family spirit; family name; family dream; strong sense of mission/vision	Can't keep family issues out of business; inability to balance family's and business's need for liquidity; lack of objectivity; inward looking; emotionally charged decision-making; can't separate work and family; rivalries
Time	Long-term perspective; committed; patient capital; loyalty; deeper ties; trust built up over time	Hard to change; tradition bound; history of family affects business decisions; trust affected by early disappointments
Succession	Training can begin early; mentoring a life-long process; can choose when to leave	Family issues get in way; unwillingness to let go; inability to choose a successor
Ownership/Governance	Closely held; family owned; high degree of control; earnings are motivators	May sacrifice growth for control; do not have to answer to stockholders; often no outside board of directors; high premium on privacy
Culture	Innovative; informal; flexible; creative; adaptable; common language; efficient communications	Founder's role stifles innovation; inefficient; highly emotional; resistant to change; reactive; high risk for conflicts
Complexity	Can foster creativity; rich interplay of roles and goals	Must be managed to avoid confusion; can be a drain of resources and energy

Table 2.Source:http://familybusinessconsulting.com/resources/strengths.html

General Challenges facing FOBs

Globalization has led to severe competition and increasing consumer demands.Every business organization has a unique set of challenges and problems. The family business is no different. Many of these problems exist in corporate business environments, but can be exaggerated in a family business. Family business goes through various stages of growth and development over time. Many of these challenges will be found once the second and subsequent generation enters the business.

A famous saying about family owned business in Mexico is "Father, founder of the company, son rich, and grandson poor" (Padre noble, hijo rico, nieto pobre). The founder works and builds a business, the son takes it over and is poorly prepared to manage and make it grow but enjoys the wealth, and the grandson inherits a dead business and bank account.

Following are the major challenges face by the FOBs.

1) Mostly the FOB control is centralized and influenced by tradition instead of good management practices.
2) There is no documented plan or long term planning.
3) Hiring family members who are not qualified or lack the skills and abilities for the organization. Inability to fire them when it is clear they are not working out.
4) Absence of clear policies and business norms for family members.
5) Lack of outside opinions and diversity on how to operate the business.
6) Dividends, salaries, benefits and compensation for non-participating family members are not clearly defined and justified.
7) Roles and responsibilities are not clearly defined.
8) Long term planning to cover the necessities and realities of older family business members when they leave the company.
9) Family problems will affect the business. Divorce, separations, health or financial problems also create difficult political situations for the family members.
10) Most family organizations do not have a plan for handing the power to the next generation, leading to great political conflicts and divisions.
11) No knowledge of the worth of the business, and the factors that make it valuable or decrease its value.
12) Decisions are made day-to-day in response to problems. No long-term planning or strategic planning.
13) Provoked by role confusion, emotions (envy, fear, and anger), political divisions or other relationship problems.

IV. Why Corporate Governance is Crucial for Family Owned Businesses

Increasing growth and globalization has brought many challenges for family businesses. The way you deal with them can mean the difference between success and failure.

Many of these challenges can be tackled by adopting sound corporate governance systems.

A. Managing Growth

As family firms expand, the relationship between owners, managers and employees becomes more complex. A good corporate governance system puts in place the right policies to manage this complexity. It creates a solid organizational structure that clarifies roles, reporting lines and delegation of responsibility. Corporate governance also draws the line between ownership and management and separates policy direction from the day-to-day running of the company.

B. Succession Planning

Leadership succession is a challenge for all companies, but particularly for family businesses. According to Gatamah, for good corporate governance system for FOBs, succession planning, formalized decision making and cultural factors are very important [7]. To ensure that leadership transition does not disrupt your company's growth, you need to have clear policies for the selection of the right family member. Successful family businesses are the result of years of hard work and dedication. To pass on this success, corporate governance needs to be made part of the family firm's culture.

C. Preserving Family Harmony

Family members may have conflicts among themselves on the running of the company. A solid governance system helps resolve such conflicts allowing family members to focus on other key issues.

D. 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 to the sustainability of your business.

E. Ensuring Fairness

Open decision-making and procedures that ensure fairness in evaluating and rewarding both family and non-family employees are essential tools in avoiding tensions and raising the reputation of your company.

V. Good Governance Practices:

For the FOBs, good governance makes all the difference. Family firms with effective governance practices are more likely to carry out strategic and succession planning. On average, they grow faster and live longer. The guide recommends a responsibility on the directors to exercise "reasonable care" in carrying out their duty in a manner consistent with relevant laws and regulation, as well as the articles of association and resolution of the shareholder's meeting.

A. . Board of Directors

The board shall have a reasonable number of members and shall include a balance of executive and non-executive directors (including an independent non-executive director) to facilitate effective and objective board management.

The number of directors should be fixed according to the company's size, age, nature of business operations, and future plans, ensuring effective and efficient governance. The board should comprise a minimum of five directors. A casual vacancy on the board of directors shall be filled by the remaining directors expeditiously. The company should set a certain percentage of board members to be designated as non-executive. Numbers will vary with the size of the board, but at least one director should be non-executive. Non-executive directors should be identified by the family council and elected by the shareholders.

B. 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.

The family council shall serve as a platform for communication and consultation in connection with the family business, and to give guidance to directors representing the family about the family's interest in the policies adopted or to be adopted by the company. In particular, this council shall play a major role in resolving conflicts and issues concerning succession. Minority shareholders may seek assistance through family councils to resolve this issue. During the selection of a chief executive, the council should make its recommendations to the board of directors, which shall give due consideration to these recommendations.

C. Employees & Other Stakeholders

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.

D. Ethics, Disclosure, and Transparency

The organization should be governed in an ethical and transparent manner under effective accountability mechanisms. Transparency is in the heart of corporate governance. 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. Therefore, when one looks at any code of corporate governance at any country, it is evident that transparency and disclosure of information is the biggest block in all codes (look for example at the Egyptian code, the combined code of England, the King report of South Africa, the OECD code, and Sarbanes Oxley of the USA). 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.

VI. Conclusion

Corporate governance studies have mostly focused on highly dispersed corporations. However, there is an important need for research exploring the governance structure of family-owned firms. This paper also emphasizes on the importance of sound corporate governance practices for the family owned businesses in Pakistan. The study shows the importance of family owned businesses in the country economy. Research also highlights the strengths and weaknesses of the family owned business. Family businesses tend to emphasize high quality, invest for the long term and develop loyal relationships with employees and key stakeholders. This can make them tough competitors. At the same time, family businesses also tend to focus on issues and tensions within the family. Research indicates the importance of corporate governance in the family owned business and also describes the sound corporate governance practices that make the sustainability and profitability of the family owned business in Pakistan. Corporate governance will ensure that FOBs are transparent enough to satisfy various stakeholders such as suppliers, customers, and creditors. The company's annual external audit should be conducted by a firm of chartered accountants. The audit committee shall ensure that the auditors appointed by the company are independent and possess appropriate resources to conduct an effective audit. Disclosure should be made of all material matters regarding the organization, including financial position, performance, and governance of the company. The annual financial statements of the company should be prepared in accordance with a recognized framework of accounting and financial reporting. The directors shall prepare an annual report for submission to the shareholders that includes the annual financial statements and a review of the financial and operating performance of the company during the year. The directors' review should also include comments on the company's strategy, including any significant projects and initiatives, as well as key risks related to its activities. Having good governance practice will build confidence among capital providers of the family owned business. Family owned businesses thereafter establish boards of directors in which many of the family members are present. Meanwhile, companies start to introduce various provisions of corporate governance including more non-executive and independent directors, board committees, bylaws and company codes. By the end of the process, the FOB does not differ from any other well-governed organization.

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