

CORPORATE GOVERNANCE IN FAMILY BUSINESS

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Abstract: Family businesses constitute the world's oldest and most dominant form of business organizations. Corporate governance is one of the key factors that determine the health of the system and its ability to survive economic shocks.

Good corporate governance strengthens and clarifies the activities of the family firm while improving its competitiveness. Proper functioning and transparency of the roles and responsibilities of all organs in the firm are in the interest of the owners, other stakeholders and the whole company.

The success of family firms is dependent on their owners. Owners who are unanimous about the direction and means for developing their firm, and who select the best representatives from among themselves and external professionals to the firm's administration are able to run profitable and successful family business. Controversies, uncertainties, and diverse expectations among the owners will dissociate and weaken the business, family and ownership. Good corporate governance offers a clear, concrete tool to commit all stakeholders of the firm and to ensure their responsibility in their own activities. Majority owners who are capable and active are undisputed resources for family firms. This paper showcases on the need for good corporate governance practices with respect to Ownership, Business and the family.

Key words:

Governance, Ownership, Governance and business, rewards, auditing, managing director, next generation

Conceptual Overview

Family business is the oldest and most common model of economic organization. The vast majority of businesses throughout the world—from corner shops to multinational publicly listed organizations with hundreds of thousands of employees are considered family businesses.

In a family business, two or more members within the management team are drawn from the owning family. Family businesses can have owners who are not family members. Family businesses may also be managed by individuals who are not members of the family. However, family members are often involved in the operations of their family business in some capacity and, in smaller companies, usually one or more family members are the senior officers and managers. In India, many businesses that are now public companies were once family businesses. Family participation as managers and/or owners of a business can strengthen the company because family members are often loyal and dedicated to the family enterprise. However, family participation as managers and/or owners of a business can present unique problems because the dynamics of the family system and the dynamics of the business systems are often not in balance.

The Need of Corporate Governance in Family Businesses

Most small independent companies are family businesses; most family businesses are also small. In most small family businesses management and ownership coincide. In view of this the need for good corporate governance practices in family businesses cannot be underestimated. Smaller family-owned businesses are often operated with a degree of informality that is both natural and efficient. The thought is that "corporate governance norms" are for someone else's business—the big guys with their in-house lawyers or big legal budgets. That attitude can be costly, particularly for a smaller, owner-operated business. Family business governance encompasses both corporate governance, typically in the form of a board of directors, and family governance, typically in the form of a family council. Within each, there are many choices regarding degree of formality and levels of participation. There is no "one-size-fits-all", and while there are certainly "best practices" for each, even the best of these requires adaptation in order to function well in each individual family and family business circumstance. Family businesses are fundamentally different in corporate governance from widely held public companies. These differences derive primarily from the discrete nature of their ownership. Family ownership concentrates control and allows greater agency in governance.

Family firms have great importance for local and regional economies and bring stability and permanence to their regions. The owners' regional commitment is strong and therefore the domicile of the firm often remains the same. They act usually as engines for regional economic development, since they have a positive attitude towards growth, and their own growth is usually more

profitable than that of other companies. The owners of family firms as persons are committed to the development and continuity of their firms.

Different roles in family firm governance .Family firms are characterized by different roles related to business, ownership and family.

Good Governance amid Ownership

Owner, active in governance has three simultaneous roles: as family member, as owner and as manager. This kind of owner is a member of the board or the management.

Owner, non-active in governance is a family member and owner. This kind of person represents long term ownership.

Non-owning, active in governance family member has two roles: as owner and as manager. This person is typically a spouse (in-law) or representative of next generation, who does not have the ownership yet, but is actively participating in business.

Non-family member, active in governance can be a member of the board or management. Non-family member owner is usually a capital investor or a managing director, who owns shares of the family firm. Non-family members bring capital and know-how to family firms.

Family members, who have no role as owner or manager, are typically spouses (in-laws) and representatives of Next generation. Family is a source of continuity, values and commitment.

The recommendations of good corporate governance in family business are illustrated with three circles – ownership, business and family. The below illustration improves the understanding of the different roles of each agent within family firms, as well as how they are expected to behave in these roles, how these roles are interrelated and how they materialize within governing bodies of the company.

➤ **Annual meeting of shareholders**

At the annual meeting, individual shareholders may use her/his official right to speak and question, as well as decision-making authority, on matters related to the company. The owner should be cautious in her/his actions and speech, since they are usually carefully followed and often acted upon accordingly – regardless of whether this was about a joint action policy to be taken by all shareholders or merely a whim given by an individual owner.

The board of directors prepares the annual meeting in accordance with the company act and company by-laws. The matters decided at the annual meeting are accordingly defined. At annual meetings, shareholders decide on matters such as the composition of the board of directors and the disposal of distributable funds. These decisions are, however, extremely important in terms of the company's success. The decisions should take into account the values and dividend policy of the family firm as well as the company act.

➤ **The Board**

In family firms, the role of the active majority shareholder in forming the board is decisive. Widely distributed and investor-driven ownership transfers the board nomination suggestions to the current board of directors which is familiar with the present situation of the company and knows best the capabilities needed for the firm.

In family firms, the role of an owner who acts as the chairman of board is emphasised. Efficient board work can be guaranteed by using the written annual protocol of the board. In those cases when the managing director is from the outside of the family, it is usually in the best interest of the owners that at least the chairman of board is chosen from amongst family owners, as this guarantees close, responsible ownership of the family firm while assuring the control of the owners concerning the long-term development of the firm.

➤ **Rewarding the board**

The aim of rewarding is to motivate the board members and enable recruitment and retain the best board members. It is wise to emphasise clearly to the owners the rewards of the board members and how they are defined, as well as, all their financial connections to the company. The annual meeting decides on the rewards provided to the board.

It is useful to pay compensation to the board members that is both competitive and motivates them. Even if the membership in the board is a position of trust from the owner's side, the compensation nevertheless indicates how much the work of the board is appreciated and what is expected from this work. Thus, paying only a minimum compensation may lower the quality of the board work. Many of the board members who are experienced and appreciated do most likely have membership on more than one board, in which case there is competition for their use of time. Through appropriate rewards, the company can increase the board members' interest in committing more time and effort to this specific company.

➤ **Auditing**

In family firms, the auditor may in addition to the auditing act as a general advisor at least in the early stage of business activities. While focusing on research and development, production, sales,

and marketing, an entrepreneur and family firm may have less time to devote to clarifying a complex legislation environment. Traditionally, auditors have had an important role in this respect.

In family firms, it is highly important to pay attention to the role of the auditor, who has been selected by the shareholders and who is an adviser to the management team. In order to avoid conflicting situations, especially in smaller family firms (the auditor is auditing his own advice), the executives of the company should aim for a situation in which the auditor and the advisor are different persons. Although this arrangement might be more expensive, especially at the beginning, it will better serve the interest of the company and its shareholder over the long run. In this manner, both the auditing and, for instance, tax consulting, are more objective and frequently more professional, since both of these fields of expertise nowadays require special skills.

Good governance and the Business

➤ **Managing director**

The managing director is hired and dismissed by the board of directors. When selecting the managing director, it is important that the person in question is qualified and suitable for her/his position. Qualified refers to those professional qualities needed to manage independently and successfully the activities of the company. Suitability refers to the compatibility of principles and operations with the values and practices of the family firm. The compatibility of the managing director in the family business is defined based on the fit with the practices of major owners. This is the basis for business success in accordance with the best interests of the family firm.

For family members, the qualifications of the managing director must be the same as for others who would be hired as a managing director. It is useful to identify over the long-term potential candidates for operative management within the owner family. This is the way to confirm that the family members have a chance to participate in the operational activities of the company in accordance with their own personal skills.

➤ **Rewarding the executives**

Executive compensation must be competitive in order to gain the most qualified and motivated management. A competitive salary also decreases the risk of losing the executives to other companies.

The reward system should estimate the influence of different elements of compensation on the motivation of the executives to create wealth for the owners, as well as, the cost effects of these different elements. In family firms, rewarding executives with share ownership might be difficult, though it could be possible if the family ownership or power structure is not excessively diluted or distorted.

Good governance and the family

➤ **Communications and interaction**

Communications and interaction are vital in family firms especially amongst the family members. The representative members of the Family Council represent the voice of the family and are responsible for communicating information on matters dealt with at the formal meetings to their family or family line. This interaction might be strengthened, for instance, by arranging a social event at the same time as the annual meeting of shareholders.

➤ **Commitment**

Generally, the Family Council is founded in order to commit family members to responsible ownership and the owning family. The Family Council provides a forum for pondering the continuity of the company and family ownership, as well as for discussion regarding the common will (alternatively in the Council of Owners), training of the next generation, and problems related to competition between family members. The Family Council faces the challenges of the future by raising family members into good owners.

➤ **Guaranteeing the unity of the family**

The Family Council aims to maintain family harmony through its existence and activities. It aims to maintain family connections and internal communication within the family, as well as promotes understanding of the role of the owner. The founding of the Family Council is especially recommended for increasing interaction between family members.

➤ **The next generation**

Membership in the Family Council might be a useful way to familiarise the next generation with activities in the family firm. The Family Council may act as a platform for preparing family members for membership in other bodies, including the governance and administration of the family firm, thereby committing the next generation to various possibilities, duties and responsibilities of ownership.

The owners are obliged to follow the rules of good corporate governance, and the Family Council is not allowed to take a public stand regarding the activities of the publicly listed company.

The guiding principles for family firms allow the owners of family firms to create the rules of ownership and to get them approved by as many owners as possible. Success in this project requires interaction and discussion within the family. This interaction will also commit the parties involved to follow commonly agreed rules. The most important factors in this process are transparency as well as clearly defined tasks and roles of different institutions for guiding the corporate governance of the company.

Each family firm has special characteristics that should be utilised in the development of good corporate governance. When changes occur in the company, ownership or family, for instance, in the form of a change of generation, it is wise to update the governance structures. At best, good governance can provide a family firm with an active, continuous additional value and competitive advantage. The aim of good governance in family firms is to ease and make the governance of the company and the family more efficient.

Due to the nature of corporate governance and its requirements, some family business owners may believe that attention to corporate governance is unnecessary because there is general agreement on the operation of the business, and no one (other than,

perhaps, the Internal Revenue Service) is looking over the shoulders of management to evaluate how things are done. Perhaps the business has operated for generations with management by consensus, expressed verbally and not committed to writing. However, this assertion is wrong because circumstances can change: family disputes may arise; long-simmering resentments may bubble to the surface; the business may hit a rough patch; and creditors may be looking for opportunities to enforce claims against shareholders or directors of the company. It is not only when things start to go wrong that the level of attention to corporate detail should become a factor in family businesses.

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