BENNETT COLEMAN & CO LTD

THE ECONOMIC TIMES

CISCO, IBM TO MERGE TECH SUPPORT BIZ
EMERGING BUSINESS & IT: PAGE 6

INDIAN MKTS AMID GLOBAL VOLATILITY
PERSPECTIVES: PAGE 15

CAREER & BUSINESS LIFE: PAGE 7

AHMEDABAD | BANGALORE | CHANDIGARH | CHENNAI | HYDERABAD | KOCHI | KOLKATA | LUCKNOW | MUMBAI | PUNE   WWW.ECONOMICTIMES.COM   TUESDAY 13 MARCH 2007 | NEW DELHI | 32 PAGES | Rs 2 ONLY

Generation gap: Holding rein in family-owned firms

Sharing of power, which the acceptance of non-family managers requires, is one of the hardest issues for family firms to come to terms with, says **Sumant Batra**

The corporate governance debate finds its origin in the need to accommodate demand for capital and protect diffused investors. Reforms in corporate governance have, therefore, largely remained concerned with improving the legal and regulatory framework of listed firms which access funds from the capital market and have large number of investors. As a result, in the contemporary debate on governance, the importance of non-listed companies has been largely ignored although bulk of economic activity in India is generated by them. The preponderance of non-listed firms is family-owned. Family-owned firms are one of the foundations of the country's business community. The manner in which these companies are governed is crucial to the contribution they make to the national economy.

While there are substantial similarities in corporate governance problems and solutions devised for the listed and family firms, the typical characteristics and organisational structure of family-owned companies produce a variety of issues such as ownership and control, role of professional management, transparency, education and awareness. The governance of family firm is in many ways more complex. Family relationships have to be managed in addition to business relationships. The shares in non-listed companies are generally concentrated in the hands of one or several shareholders who frequently belong to the same family.

These firms are characterised by a smaller number of shareholders, no free market for companies' shares, and substantial majority shareholder participation in the management, direction and operation of the company. Regardless of their motives, it is unavoidable that controlling shareholders would expect some level of private benefit to compensate them for their monitoring costs and reduced liquidity. Most family firms combine the role of owner and controller; manager and governor; actor and director; and ironically, preserver and destroyer. Personal relationships are important in a family firm. Those involved cannot stand back and look at business separately from family issues. Subordination of boards to management, self-dealing, manipulation of accounts, related party transactions and lack of transparency in the allocation of finance can contribute to the lack of credibility these businesses suffer from.

Generation growth also creates peculiar corporate governance issues for family firms. In the first generation, owners control the board of directors and are responsible for the management. Absence of distinction between capital and function and independent auditing make procuring capital challenging often, compelling the entrepreneur to reinvest earned profits. Second generation creates several owners, not all of whom have same interest, or role, in the enterprise leading to suspicion, or dispute, over fair appropriation of profits, investment policy, or business strategy. The sharing of power, which the acceptance of non-family managers requires, is one of the hardest issues for family firms to come to terms with.

The proportion of non-family to family managers increases. In the next generation, the enterprise frequently attains a dimension which requires a high degree of professionalism which the owners may not always be able to meet. Interests of family tend to diverge leading to tension. Bringing in outside management becomes desirable. This creates need of external capital. As the firm grows, single family management group splits into three: family owners; family owners/managers; and non-family managers. To complicate matters further, some owners/managers may see themselves as having responsibilities of a trustee for shareholding relations. Managing these relationships depends on those involved being clear about their own roles and responsibilities and that of others.

(Author is partner, KDB Associates)

(To be concluded)

BENNETT, COLEMAN & CO LTD

THE ECONOMIC TIMES

IIM CROREPATI CLUB GROWS TO ELEVEN
CAREER & BUSINESS LIFE: PAGE 9

DISPOSABILITY & INDIAN CONSUMER
BRAND EQUITY

MONEY & BANKING: PAGE 13

AHMEDABAD | BANGALORE | CHANDIGARH | CHENNAI | HYDERABAD | KOCHI | KOLKATA | LUCKNOW | MUMBAI | PUNE WWW.ECONOMICTIMES.COM WEDNESDAY 14 MARCH 2007 | NEW DELHI | 40 PAGES | Rs 2 ONLY

Familial leanings & investor interest

Family-owned businesses are trying hard to come to terms with the fact that potential investors are making good governance practices as a pre-condition. Recent high profile splits, succession issues and family disputes are examples of some casualties of this struggle, says **Sumant Batra**

SHAREHOLDERS in publicly-held companies, unlike those in unlisted firms, are protected mostly by mechanisms aiming to constrain large shareholders due to the presence of market for transferable shares, and by reputation agents. Accountants, rating agencies, and stock exchange watchdogs play an important role in both reducing information asymmetries and detecting fraud in listed companies. These safeguards may not be available in family-owned-and-managed businesses.

The liberalisation of Indian economy, the decreasing international barriers to trade and rapid face of technological change over the past decade have created new strategic and organisational opportunities for family-owned companies. At the same time, it has exposed them to unique challenges.

Private equity investors, typically, demand greater professionalism in corporate activities of companies they identify for investment. Contracting parties have higher confidence in well-managed companies. The new company law is expected to introduce important changes that would necessitate adjustment and orientation of corporate governance by family-owned companies. These businesses are trying hard to come to terms with the paradigm shift in doing business. Recent high profile splits, succession issues and family disputes are examples of some casualties of this struggle.

Besides having to cope up with inevitable need to bring about rapid strategic, operational and financial transformation, family businesses have another additional agenda at hand: Rewriting the role of the family in business in the fast changing economic scenario. The role of the members of the family on both, the family and the business front have got so intermingled that to segregate them is an uphill task. In this effort, the family businesses need policy support from the government and guidance from bodies such as the National Foundation of Corporate Governance (NFCG).

The exact role of legal and regulatory framework in solving corporate governance problems of family-owned companies is still unclear. As various corporate scandals hit headlines, some feel regulation will make these companies more accountable to the society. They also emphasise the need to create level playing field for listed and non-listed companies. Some family-owned companies may involve large public interest due to high exposure of lending by public financial institutions or the activities they undertake in public utility areas. Those against argue that regulation adds substantial costs in carrying out normal business activities that outweigh possible linking benefits. It also discourages the businesses to take even legitimate risk. Notwithstanding divergent views, it is not disputed rules and principles are necessary to provide the basis for an effective corporate governance framework; define the role and responsibility of the board; rights of shareholders and the responsibilities of management; and set out norms for enhanced disclosure and transparency, to improve the governance of closely-held companies.

Unlisted companies arguably demand some stringent regulation to curb appropriations and settle expectations. However, law cannot specify corporate governance in its entirety. There are behavioural norms that legal framework can't address. This task needs to be addressed by a judicious mix of legislation regulation and suasion. Corporate governance codes can supplement and strengthen the legal provisions. They can supply principles for standard setting and enhancing enforcement by markets. In practice, these are soft law that can easily translate into hard law constraints. Such guidelines could be in the form of advice providing the business participants with recommended solutions to complement the contractual flexibility of company law rules; focal point solutions to corporate governance problems among business participants; and assist business participants in interpretation and implementation of good governance practices. These could contain recommendations on different ownership and control structures of family-owned companies, composition of board of management, transparency requirements, accessing outside capital, and strategies for succession planning and conflict resolution.

The family-owned companies in India hold tremendous potential. They are eager to grow and expand. They recognise the benefits of good corporate governance and its role in graduating to next level. They are becoming conscious that absence of good corporate governance will act as deterrent to their plans. They need guidance. Initiative is required from policy makers and supporting institutions such as NFCG, ICSI and others to take up this cause on a priority basis. A task force is needed to undertake in-depth review and analysis of corporate governance issues of family-owned businesses and make recommendations for possible solutions.

(THE AUTHOR IS PARTNER KDB ASSOCIATES)

(THIS IS THE SECOND AND CONCLUDING PART OF A SERIES THE FIRST PART OF WHICH APPEARED ON MARCH 13)

CHANGED RULES

The new company law is likely to introduce changes that would necessitate adjustment and orientation of corporate governance by family-owned companies

ACCOUNT ABLE

Role of legal & regulatory framework in solving governance problems of family firms is unclear, but some feel regulation will make these firms more accountable