Corporate Governance in Family-Run Businesses in Thailand

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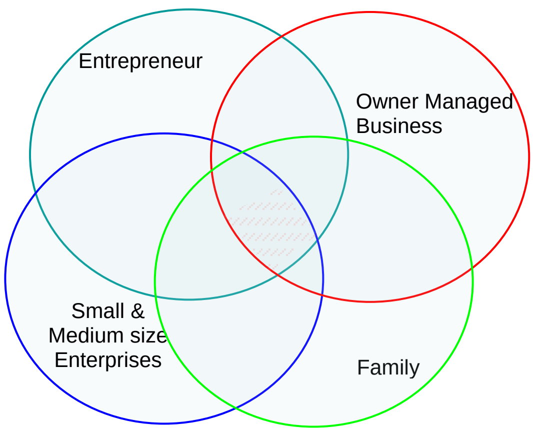
Introduction

Good corporate governance has become a universal business and management quality issue in recent times. "Corporate Governance", a term that scarcely existed before the 1990s, is now universally involved whenever business and finance are discussed (Keasy, et al, 2005). The rule of law does not always appear to suffice when preventing profit-oriented entrepreneurs from manipulating the market using professional tricks. Altogether, a focus on governance, rather than on mere rules has become important. However, the process ultimately has to add value to the stakeholders' assets, return on investment, return of equity etc.

This particular study will focus on the corporate governance of family-run companies in Thailand, the firms that are owner-managed or founder-run (Dalton, 2005). The Stock Exchange offers them to funding sources, an alternative to the costly banking system. As they grow out of the family circle in collecting funds, they get into the classic principal-agency problem. Management of "Other People's Money" (OPM) is a genuine concern.

The related academic fields are shown in a Venn diagram below (Neubauer and Lank, 1998). Here, we will focus on the amalgamated center. The good governance practices of the owner-managed business, which is usually a small or medium size business where family members of the entrepreneurs take stakes, is the focus of this study.



Conceptual and Methodological Framework

Modern economic theories on analyzing company governance and its relationship with performance, management leadership, entrepreneurship, profit, equity and other related issues and the ramified influence of all these on a national economy and beyond are employed in the study. The study includes a review of literature, interviews of various stakeholders, and round table discussions with institutions, regulators and academicians.

Defining Corporate Governance

Before producing a working definition of corporate governance appropriate for the Asian environment, some of the most accepted global definitions will be first cited and discussed.

The Cadbury Committee was set up in May 1991 by the Financial Reporting Council of the London Stock Exchange. The committee defined 'corporate governance' as "…the system by which companies are directed and controlled". While making a normative comment on corporate governance, the Cadbury report also suggested that the "board of directors should be free to drive their companies forward, but exercise that freedom within a framework of effective accountability" (Cadbury Report, 1992).

The Hampbel Committee, again formed in the UK in 1995, added that the single overriding objective of companies is the preservation and greatest enhancement over time of their shareholders' investment (Hampbell, 1998). Joan Li (2000) further claims that corporate governance must integrate Integrity, Transparency, and Accountability in order to maximize shareholders' wealth, stakeholders' wealth and ultimately the wealth of the society.

The principal elements of effective corporate governance are the following:

1. protection of the rights of minority shareholders

2. transparency (including disclosure of relevant and reliable financial and operational information, information on ownership and control, and information on the internal processes of management)

3. responsible directors capable of independently evaluating and approving the joint stock company's strategy, business plans and decisions, independently hiring, monitoring and, when necessary, replacing management and auditors

Thailand's Crash and Subsequent Achievements

The 1997 crisis in Southeast Asia has been a significant event in economic history and some theories suggest that it started from the "crony economics" of Thailand. Allegedly, family-run businesses borrowed money from banks that were also either owned or otherwise controlled by the same families. Therefore, there was a collapse of the whole economy.

However, the theory of crony economics should first be debated on as there were other macro economic reasons behind the crisis. There were substantial policy reforms which led to substantial exports and foreign direct investments, as well as an economic growth rate that exceeded the world average. In many countries of the region, governments encouraged the ‘borrow abroad and lend domestically’ policy. Later, when the currency was devaluated, the mismatch triggered an abrupt failure of economic functionalities (Islam, 1999).

Thailand had the world’s highest growth rate in the decade before 1997. In 1997, the Thai government floated the Baht. The economy contracted by 10%. Yet the growth rate bounced back to 5% soon. The solution was found in basic Keynesian theory, which is to pump in money into the economy. Thailand followed a distinct economic growth model: good economic growth accompanied by a fairly equitable distribution of wealth (Fang, 2001). However, part of the Asian crisis (post 1997) has been attributed to bad governance, which includes reckless lending and investments (for banks), expropriation of company funds by directors, managers and large shareholders, shady business deals and poor audit (Thai Institute of Directors, 2001). This realization has led Thai regulators to raise themselves to the international standard of good governance.

The Stock Exchange of Thailand framed a set of crystallized Code of Good Governance. The Institute of Directors (IOD) was established. The Thai Securities & Exchange Commission, unlike in most countries, is chaired by the Minister of Finance. It demonstrates Thai national efforts to continue strengthening good governance practices.

The SET Code of Corporate Governance

The 15 Principles of Good Corporate Governance of the Stock Exchange of Thailand (SET) are well published and surveyed by IOD. In this study, the principles’ underlying philosophy is examined. The principles are expressed in the form of questions to retrieve direct measurable answers.

1. Does the company have its own written corporate governance rules that clearly describe its value system and board responsibilities?
2. Does the company offer other ownership right beyond voting?
3. Does the company explicitly mention the safety and welfare of its employees?
4. What is the quality of the notice of the Annual General Meeting?
5. Does the company have a corporate vision?
6. Does the company have a transparent ownership structure?
7. Does the board of directors provide a code of ethics and statement of business conduct for all directors and employees?
8. Is there any membership to allow minority shareholders to influence board composition?
9. Is the chairman an independent director?
10. Do the shareholders approve the decision on the remuneration of board members or executives annually?

11. Does the board appoint independent committees with independent members to carry out critical responsibilities such as audit?
12. Does the company have an internal audit operation established as a separate unit in the company?
13. Does the company have a board of director's report in the annual report?
14. Does the board disclose critical information to the public through effective channels?
15. Does the disclosure include profit forecast and operation guidelines?

The Family Affairs: Of the family, by the family, for the family?

Sizeable portions of business conglomerates around the world are owned by families. There are many investors who buy shares and become owners of a corporate venture after it takes off and shares are offered to the public. Family businesses are perceived to have poor governance. It is said that they are emotion-based rather than task-based. Directors have a guaranteed lifetime membership. However, the fact is that the task of developing a business from scratch or the day-to-day management of a business cannot be done by members of the public. These exertions have to be made by a handful of special people who are wise, efficient and open to challenges.

In the US, the founding family is an influential factor in more than one third of the Standard and Poor 500 Companies. For example, Mr Rupert Murdoch controls 34% of BSkyB and has sufficient power to appoint his 30-year-old son to become Chief Executive of the giant corporation. A research by Ronald Andersen and David Reeb (*The Economist*, 2003) in the US suggested that the family firms which are publicly listed but has a board "laden with the lackeys" perform badly, and those firms with strong directors do better. A similar study of an Asian country like Thailand which graduated from a spectacular crisis will be meaningful.

Bertrand, Johnson et al (2004) provided an insight into the sociological aspect of business conglomerates in Thailand. An enquiry into family trees and business groups reveals that group heads and their brothers hold the majority of family positions. However, as the family grows and new branches of the business spread out, the wider family forms a pyramidic conglomerate.

Bertrand, et al classified family involvement into four types, namely (a) designated heirs, (b) board membership, (c) executive board membership (for publicly listed companies), and (d) ownership. The companies listed in Market for Alternative Investment (MAI) of the Stock Exchange of Thailand are largely family owned and are run or controlled by members of the family. Experience suggests that a shareholder with more than 25% of a company's voting share can control a firm because no other single shareholder would own enough voting power to challenge the former.

For purposes of this study, the Stock Exchange of Thailand arranged a round-table discussion on 22 April 2005.[1] In the discussion opened by Dr Anaya Khanthavit,[2] Professor of Thammasat University and Dr Piruna Polsiri of Durakitpandit University, the conference revealed a number of basic features of the Thai SMEs listed in MAI.

It seems that most, if not all, SMEs are promoted by family/friends groups. Family men begin businesses with their savings, and later borrow from banks. Borrowing from relatives is also common. The successful SMEs at some point of the corporate life cycle will need bigger funds and go for public equity. These companies are listed in the Market for Alternative Investment (MAI) of the Stock Exchange of Thailand (SET) where they enjoy low cash cost of fund and distress in comparison with other sources of funds. The regulatory requirements of MAI are reasonable, not too rigorous like those of the mail board listed companies. However, the companies are encouraged to match the SET code of good governance. Therefore, this study focuses on this group. Thai SMEs account for 72% of the manufacturing sector while the large ventures compose 28% of this sector. SMEs have generated 63% of employment while larger ones have generated 27%. Therefore, the political as well as the economic importance of the SMEs turns out to be most profound. So is their status of good governance.

In 2000, 50.3 % of the companies' shares were held by the controlling family. In 1996, before the economic crisis, as Khanthavit revealed, this figure was almost the same – 49.2%. Before the crisis, 55.2% of the companies had CEOs from the entrepreneur's family. After the crisis, this number has increased to 59.9%. Although the role of the family members in business has changed after the crisis, in some cases, their power has not diminished. Controlling families are actively involved in management even after the crisis caused by "cronyism".

Practices of Good Governance in the Listed Companies of Thailand

Companies listed in the Market of Alternative Investment [MAI] of the Stock Exchange of Thailand are necessarily SMEs, most of which are owned and controlled by family. They comply with the Good Governance codes of the SET which were mentioned earlier.

A case was presented for the author's consideration.

> The 107.6 million baht-company **Yuasa Battery** has a reputation in producing and marketing batteries for vehicles and instant power supply units. The Chairman and Managing Director of the company is Mr Chan Manutham. His son, Mr Kumtorn Monutham, who had been the President (CEO), passed away in 2003. Mr Chan Manutham is now 86 years old and presently holds the position of both Chairman and CEO of the Company. This appeared to be a violation of good governance principles. Moreover, the company's profitability decreased after the death of the previous president. It is assumed that a huge amount of cash was paid to the immediate family of the deceased which caused significant drop in the profitability.
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> At the age of 86, Chairman and CEO Mr. Chan Manutham maintains regular office hours and is instrumental in his service to the company. The company,

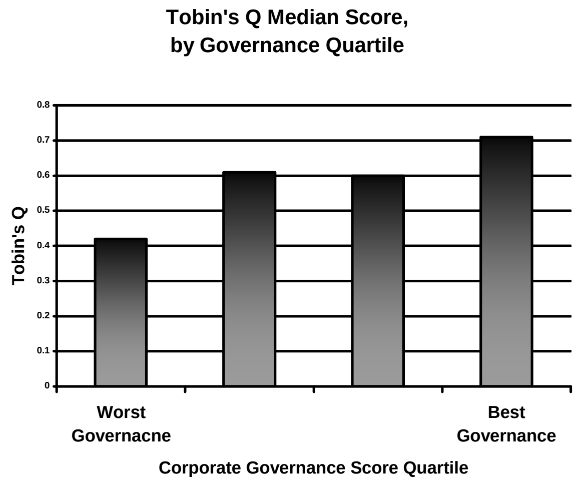
> being a Thai-Japanese joint venture, has ten directors of which four are Japanese and the rest Thai. Moreover, there are three independent directors, complying with the requirements of SET. Mr. Chan Manutham has no relative in the board of directors. In the year of Mr Manutham Jr.'s death, the company experienced a rise in manufacturing expenditures, customer services, selling and administration. It also incurred a loss of investment in equity method.

It seems that this "of the family" company has suffered in paying the immediate family of the deceased CEO, and thus the case justifies the truism part "for the family". It also seems that the company continues to be led "by the family", now under the leadership of the father of the deceased CEO, though this is not an example of good corporate governance. The company shows only partial adherence to the codes of good corporate governance. Which areas then show non-adherence to these codes? The answer can be found in areas which involve "the family". Interestingly, in the case cited above, it is the family that determines the level of company performance, whether positive or negative, and thus reveals that "family" and "performance" are very closely related in a family-run SME.

Performance and Corporate Governance

By definition, good governance is a positive notion, but its implementation cost is high. In advocating for good governance, it is therefore required to measure the performance of a company vis-à-vis the degree of compliance to the codes. Profit is the primary motive of a business venture. Better profit or expectation of better profit enhances the value of share in any rational share market. Therefore, there are attempts to measure the value of share in order to measure corporate profitability on the assumption that good governance improves business profitability and eventually increases value of share in the market.

Tobin's Q[3] is a well-accepted method for measuring the performance of a stock. The Institute of Directors (IOD) of Thailand presented an analysis in its Annual Report of 2003 using it. The analysis calculated the correlation between the corporate governance score awarded to the companies and their Tobin's Q (Thai Institute of Directors Association, 2003). The correlation is positive 0.20. The IOD report suggests that although the correlation coefficient is low, due to some other fluctuating variables, the positive development in the figure is significant enough to establish that "the benefits of good governance outweigh the costs".



To establish the positive relationship between corporate performance and governance quality, the IOD made further analysis using multiple regression tools. In the multiple regressions, the relation between corporate governance score and market performance (market price of stock) is tested for firm size, financial leverage, accounting profitability, and industry effect (as per SET Industry Classification). In this analysis, it was found that there is a positive association between corporate governance and corporate performance, although the probability attached to it is as low as 0.002.

A national sample survey on good governance again by IOD reveals that investors are sensitive to the companies with extreme governance. The sample companies were divided into four groups as per their performances. The median Tobin's Q of the top ranking companies is close to 0.75; while the worst ones' median score is approximately 0.45. The middle two groups have almost the same, around 0.45, as graphically shown above. Thus, IOD concludes firmly that "good governance benefits all shareholders".

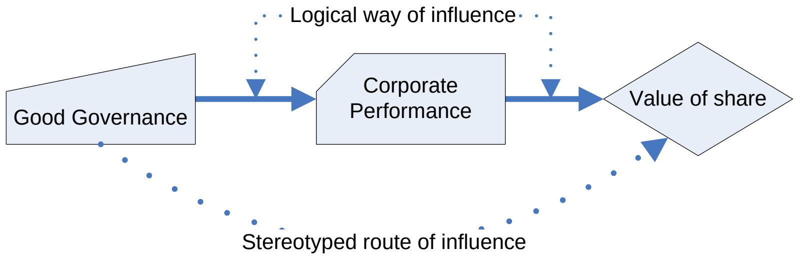
Another study done in the region may be cited in relation to this topic. Surveying 515 Korean companies, Black et al (2002) found that there is a 160% increase in share price in Korean companies from those with the worst corporate governance to those with the best. The Tobin's Q increases by 0.47. The study firmly concludes that there is a strong causal relationship between an overall governance index and higher share price in the emerging market. Morck and Young (2004) assert that control of corporate assets by wealthy families in economies lacking institutional integrity is common. It has negative implication on corporate governance and adverse macroeconomics effort. The platform of the World Bank has asserted that family control and control pyramids predominate in emerging markets and in "some industrial economies".

All these theories suggest that corporate governance help improve management of the company by closer supervision. But the most important centre part of the two tiers' causal relationship sometimes disappears. Without waiting to see the profitability attainment, investors increase the demand of shares of companies with good corporate governance; consequently, prices shoot up. The direct relationship between better corporate governance and share price probably dictates the herd behavior of general investors.

Commentary

Despite many statements and dictum on the importance of corporate governance, there is a view critical of it. There are some basic errors in the causal relationship.

It is important to see if corporate governance affects profitability and if the market value of share will be affected by the profitability. Governance and Tobin's Q may not have a direct relationship in this regard.



Yupana conducted empirical studies in Thailand and convincingly asserts that controlling shareholders expropriate corporate assets is not valid. In fact, the presence of controlling shareholders is associated with higher performance when measured by straightforward accounting measures (not price of share) such as ROA and sales assets ratio. The controlling shareholder's involvement in the management however has a negative impact on performance. It is more visible when the controlling shareholder and manager ownership is from 25% to 50%. Otherwise, according to Yupana's study, family-controlled firms display a significantly higher performance in terms of accounting measures.

However, there is no way of saying categorically whether or not all family businesses are managed well. In this regard, the work of Piruna shows that the propensity to tunnel and prop is higher for business groups in particular, if organized in pyramids. Specifically, we find that firms that belong to the top 30 business groups implement a number of restructuring activities such as expansion, executive turnover, and dividend cuts, more often than non-group firms. Among the business group firms, we find that firms with higher ratio of cash flow rights to voting rights are less likely to implement the following restructuring measures: downsizing, expansion, and executive turnover. Interestingly, even in the cases of the business group firms that are not organized in pyramids, debt increases the probability of operational restructuring. The conventional good governance codes are not able to address the tunneling through pyramidic corporate structure.

In a pioneering study, Khanthavit, Jumreornvong and Sukchrooensin (2002) examined the relationship of a firm's performance with the independence structure of an audit committee.

The study, conducted in 2002, focused on the companies listed in the Stock Exchange of Thailand in 2000. Khanthavit et al used the simultaneous equation approach to assess the possible endogenous relationships among other variables affecting the relation. Khanthavit's study reveals that the independence of an audit committee (which is the key to good governance) and the level of debt financing are determined simultaneously with the firm's performance. Audit committee independence, which is the expensive base of good governance, is exogenous to and is a ***determinant*** rather than determined by certain corporate governance mechanisms.

In other words, only the well-performing companies are practicing good governance. It is the performance which determines the degree of good governance practices. It is not good governance that brings in good performance always. Corporate governance may result in good performance but used together with a number of other managerial and financial factors.

We can therefore offer the following conclusions:

- Thai companies practice the code of good governance well. However, if the companies want to tunnel corporate assets, there are other routes. A demonstration of code practice does not guarantee protection.

- The international pressure for corporate governance in the western way was regarded by the SET, largely in the SET codes of corporate governance. SET codes are very rigorous and they comply with OECD recommendations. It is unfair of the international community to point a finger at an emerging market company.

- The author concludes that Thailand does not need to adopt western good governance code for its corporate development. Thailand, which has never been colonized, has its unique strengths and weaknesses. Family will continue to be the centre of all activities in Thailand, as in many other Asian countries. Thai family ties will always encourage individual enterprises to flourish and increase family wealth. Thailand cannot undermine the importance of family-run companies in the development of its economy, hence must not pressure entrepreneurs to implement costly governance.

- The IOD indicated companies with worst governance are also undervalued. It may be a stereotyped perceptual mistake by investors to expect a relationship between the practice of the governance code and corporate performance, a form of wishful thinking led by massive media campaign against so-called cronyism. The IOD is right in stating that while very well governed firms are rewarded and the worst ones are punished, both draw the attention of investors. The mediocre ones do not stand out hence the demand remains stagnant causing no meaningful change in price that could change their Tobin's Q score. The whole relationship between corporate governance and good performance is a vague notion, a misconception.

- The need for good corporate governance is obvious. Nevertheless, Thailand should develop something more endogenous. Thailand needs to demonstrate a good degree of compliance with the international code, but, in the last decade, Thailand has established for itself a strong economic footing. What Thailand requires is to address the issue with a more sociological than business viewpoint.

- Thailand is in a position to asianize the international codes of good governance.

Endnotes

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[1] It was an assembly of MAI listed companies, independent director and academicians.

[2] Professor Anya Khanthavit is an Advisor to the Stock Exchange of Thailand and expert in Corporate Governance as well as banking and finance.

[3] Tobin's Q is a ratio developed by James Tobin of Yale University, Nobel laureate in Economics. He hypothesized that market value of company on the stock exchange should be about equal to their replacement cost. The Q ratio is calculated as the market value of a firm's assets is divided by the replacement value of the firm's assets. A Q value less than 1 implies the stock as undervalued and greater than 1 implies as over valued.

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