

The Governance of Family-owned or Founder-owned Unlisted Companies

Family- or founder-owned unlisted companies are the most common type of company in almost all IFC's client countries, with the only significant exceptions being the transition and communist economies. Family- or founder-owned unlisted companies are defined as companies in which the founders or the founders' families have either complete ownership or effective control of the companies and, usually, a significant role in the companies' managements.¹ Family companies are particularly predominant among medium and smaller-sized companies, but in many markets even most large companies have a family as their controlling shareholder. The complex interaction of the family and the company that it controls creates several difficult governance issues in addition to those faced by other companies, including: succession planning for the family management; family versus non-family employment and promotion; equitable treatment of non-family shareholders; and the role of family meetings vis-à-vis Board meetings and shareholders meetings. The primary focus of IFC's family company paradigm is on unlisted family companies. However, many of IFC's largest investee companies are listed companies with a family as the controlling shareholder. For these clients, the family company paradigm should be used in tandem with the listed company paradigm.

Using the CG Tools

There are seven key CG Tools that are used for analyzing the governance of companies. The Instruction Sheets, Progression Matrices, Information Request Lists (which depending on the client and project characteristics can be the DDR Report Generator² or the FGA Tools) and the Sample CG Improvement Programs have been adapted for the Family Company paradigm. The explanatory note "Why Corporate Governance?", the Model Independent Director Definition and the Supervision Checklist are applicable across all five paradigms without any adaptations.

- 1) Instruction Sheet – Family-owned or Founder-owned Unlisted Companies** The purpose of this Instruction Sheet is to describe each of the key CG Tools, how they should be used and who should be interviewed in the course of either a Full Governance Assessment (FGA) or a Due Diligence Review (DDR). (A full description of the Step-by-Step Process for analyzing the governance of companies is provided in the section of the website "Applying the IFC Methodology".)
- 2) Why Corporate Governance?** This note explains IFC's approach as value-added for clients. *This explanatory note should be given to the client at the earliest opportunity in the pre-appraisal.*
- 3) Progression Matrix – Family-owned or Founder-owned Unlisted Companies** The Progression Matrix relates the five areas of governance (Commitment to Good CG, the Board of Directors, Control Environment and Processes, Transparency and Disclosure, and Shareholders Rights) to four levels of achievement. The use of a matrix framework emphasizes the importance of ongoing improvements in the governance practices of clients, rather than trying to apply rigid and static minimum standards. In particular, the Progression Matrix allows clients to assess the governance of their own company against a simple framework. *The Progression Matrix should be given to the client at the earliest opportunity in the pre-appraisal.*
- 4) Information Request List – Family-owned or Founder-owned Unlisted Companies** This list of questions and requests for documentation forms the basis for the corporate governance analysis of an IFC client. The Information Request List is organized along the same lines as the five areas of governance in the Progression Matrix. *For a FGA the Information Request List should be circulated to the company at least three weeks in advance of the on-site visit.* The company should identify a single officer who will be charged with responding to the Information Request List by providing brief written answers of one or two

¹ In many family firms the founder or the founder's family will maintain complete ownership of the company, while in others they will have a legally defined controlling stake. However, in some cases, the controlling stake may be de facto, rather than de jure, with the family exercising effective control or significant influence, even though a single family bloc does not own the majority of the shares.

² The Report Generator is an integrated tool that has the 5 key CG risks, questions for the client, documents to requests and the mitigating features to identify in producing an appropriate Decision Book report with recommendations.

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paragraphs to each of the questions and deliver these to IFC *prior to* the on-site corporate governance analysis. For the DDR, the investment officer must collect the required information from the documents or from interviews during the appraisal. If the IO elects to send a specially prepared DDR information request ahead of the site visit, an amended “questions-only” version of the Report Generator should be sent to the client. Discussions relevant to IFC’s understanding of the governance of a company will arise throughout the appraisal and diligence process. Therefore, IFC Staff is encouraged to edit the information request (FGA or DDR) as necessary before sending it to or discussing it with the client, so as to avoid duplication.

- 5) **Model Independent Director Definition** Perhaps the most frequent governance recommendation is to increase the Board’s independence from both the management and the controlling family shareholders. However, to achieve genuine Board independence, it is crucial to carefully define what it means for directors to be “independent”. This Model Independent Director Definition is often used during discussions with the client to clarify the assessment of the current Board and its future needs.
- 6) **Sample CG Improvement Programs or Sample Decision Book Section (for DDRs) – Family-owned or Founder-owned Unlisted Companies** A FGA results in the drafting and negotiation of a Corporate Governance Improvement Program (CGIP) to be implemented by the client. This CG Improvement Program should always be tailored to the circumstances and priorities for the company. However, the Sample CG Improvement Program gives a good idea of what has been negotiated with clients in the past and, therefore, they can be used as a reference point in the drafting process. The DDR always generates a section for the Decision Book and sometimes this will include recommendations for improvements. This Sample DDR Decision Book Section provides a useful reference point for the IO’s use.
- 7) **Supervision Checklist** The Supervision Checklist provides a list of key issues that should be considered by investment staff while supervising IFC investee companies and, in particular, those companies undertaking CG Improvement Programs.

Corporate Governance Interviewees

To carry out a thorough corporate governance analysis (FGA or DDR), IFC staff needs to have direct discussions with people who play a variety of governance roles in the company. A list of the people who would normally be interviewed is provided below. However, companies may differ significantly in how they apportion responsibilities and in the titles they use for different positions in the company, so it is important that IFC staff meet with those who, as a practical matter, are responsible for the principal corporate governance functions, irrespective of their job titles.

- Family owners and family senior managers
- Family members who own shares, but who do not work in the company
- Non-family, professional senior management
- Chair and members of the Board of Directors
- Chief Executive Officer
- Chief Financial Officer
- Senior lawyer for the company
- External auditors

Where applicable, the following people should also be interviewed:

- Holders of other significant blocs of shares
- Independent, outside or non-family members of the Board of Directors
- Chairs of the audit committee and other standing committees of the Board
- Corporate secretary
- Chief internal auditor
- Formal or informal advisors to the owners and managers of the company