

# *Role of Internal Audit in Family Owned Business*

December 2011



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## ***Agenda***

- 1 Overview of Family Owned Businesses
- 2 Good Practice Governance Structure
- 3 Role of Internal Audit in Governance and Risk Management

# *Overview of Family Owned Businesses*

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## ***Overview of Family Businesses***

### **What is a Family owned business ?**

A family business is an enterprise in which the majority of the votes are held by the person who established or acquired the firm (or by his or her spouse, parents, children or children's direct heirs); at least one representative of the family is involved in the management or administration of the firm; and, where the company is listed, the person who established or acquired the firm (or his or her family) possesses 25% of the voting rights through his or her share capital and at least one family member sits on the board.

### **Family Businesses are Important**

- Family businesses make up the biggest part of the companies that affect the economy.
- In the EU, 70% to 95% of companies are family businesses. In addition, these companies make up 70% of the GDP of the EU.
- In the USA, 20 million companies make up 49% of the GDP and employ 59% of the workforce and make up 78% of all new job opportunities.
- Family businesses outperform non-family owned companies in sales, profit, and other growth measures

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## ***Overview of Family Businesses***

### **Challenges**

Over 80% of Middle East businesses are owned or controlled by families. As they prepare for the next generation, they face unique challenges to achieve value both for the business and the family.

- A significant number of family businesses are to go through a generational change in the next 5-10 years.
- Family business continuity is a major concern in the Middle East
- Most family businesses have no formal procedures and structures in place to address governance issues for their family and owners.

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## ***Strengths and weaknesses of Family Owned Businesses***

### **Strengths**

- Commitment
- Dedication from family as business owners
- Family members willingness to work harder and reinvest profits into the business for long term growth
- Knowledge & Continuity: willingness to pass on knowledge and experience to the next generation
- Reliability & Pride: Family name, reputation and pride associated with the business
- Stronger ability to act quickly in critical matters and finance.
- Speed in making a decision due to freedom of skipping policy and procedure.
- Strong will to keep the family business alive by members of the family.

### **Weaknesses**

- Informal management structures
- Ineffective oversight & control mechanisms
- Non-alignment of incentives among family members/family conflicts
- Lack of discipline

# *Good Practice Governance Structure*

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# ***Challenges facing Family Owned Businesses***

## **Continuity planning**

- The family philosophy
- A commitment / common vision

## **Succession planning / Generational change**

- Ownership / Management
- Leadership and transitional rules

## **Conflict management**

- Forum and governance for family owners, both active and passive
- How to create business relationship within the family

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## ***What do successful families do to face these challenges?***

- Decouple the ownership issue of the family business from the management issues.
- Create a Family Council or Shareholders Assembly as a forum to discuss ownership issues.
- Build and agree a set of rules or protocols.
- Leave the management to get on with the effective management of the company, but;
- Set up good corporate governance and communication between the management board and the Family Council/Shareholders Assembly.

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## ***Benefits of developing a proper structure and family protocols***

### **A united family - family with one voice!! :**

- disunity destroys values and families

### **Understanding of Ownership and Management issues :**

- responsibilities of Owners and Management
- communication between owners and management

### **Provides clarity to Owners :**

- our commitment to the business and each other
- how to deal with issues – protocols/constitutions
- ownership decisions

### **Provides clarity to management :**

- owners objectives
- owners requirements on risks, returns etc

### **Legitimize Family Leaders :**

- Collective support

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## ***Benefits of developing a proper structure and family protocols***

### **Obtaining support from the passive members :**

- by respecting their rights
- fewer exits

### **Less interference in the business :**

- proper forum for shareholders
- good communication

### **Integrates incoming generations :**

- transitional arrangements
- family council
- mentoring and training

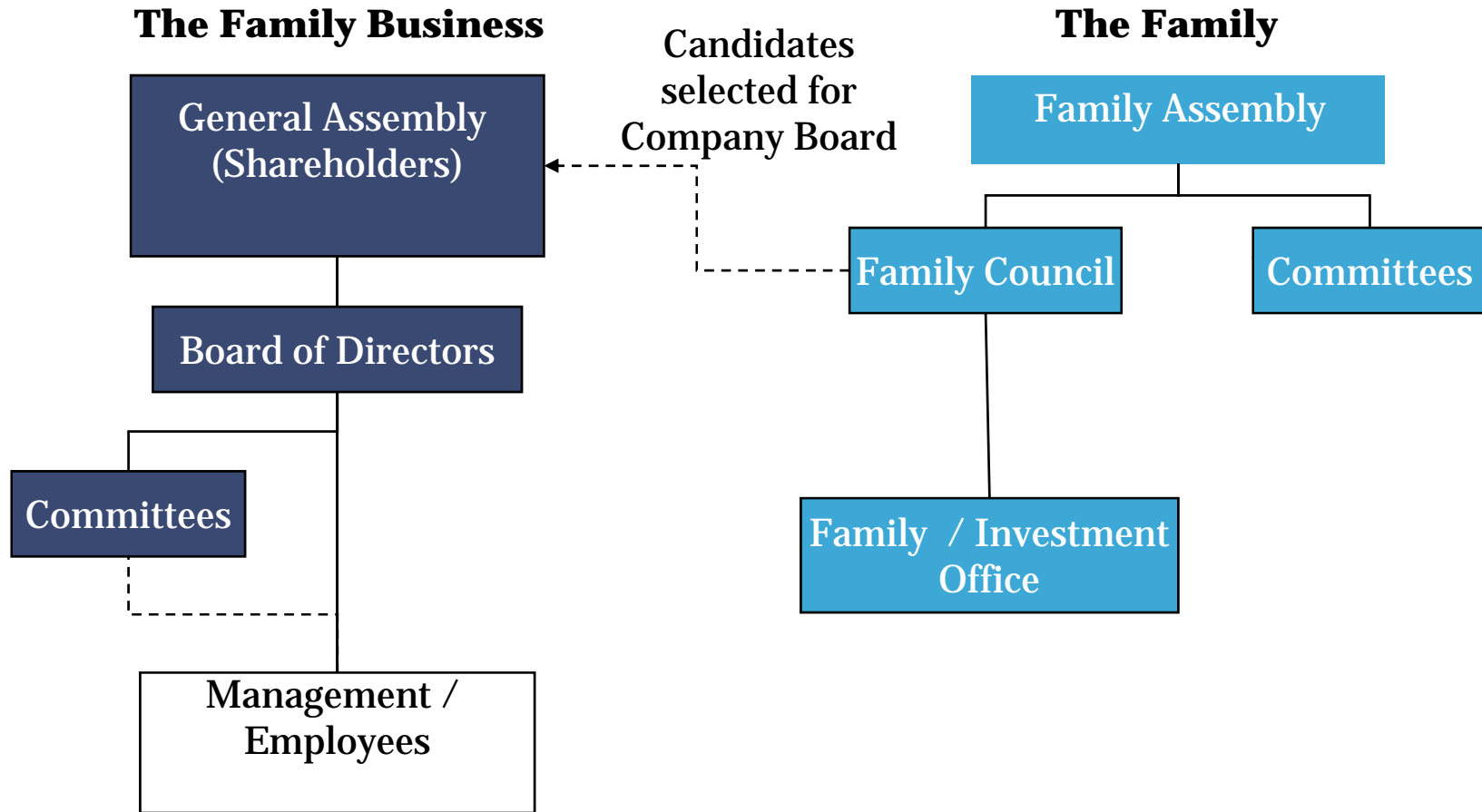
### **Provides clarity on family employment :**

- employment criteria
- eliminates “silo” mentality

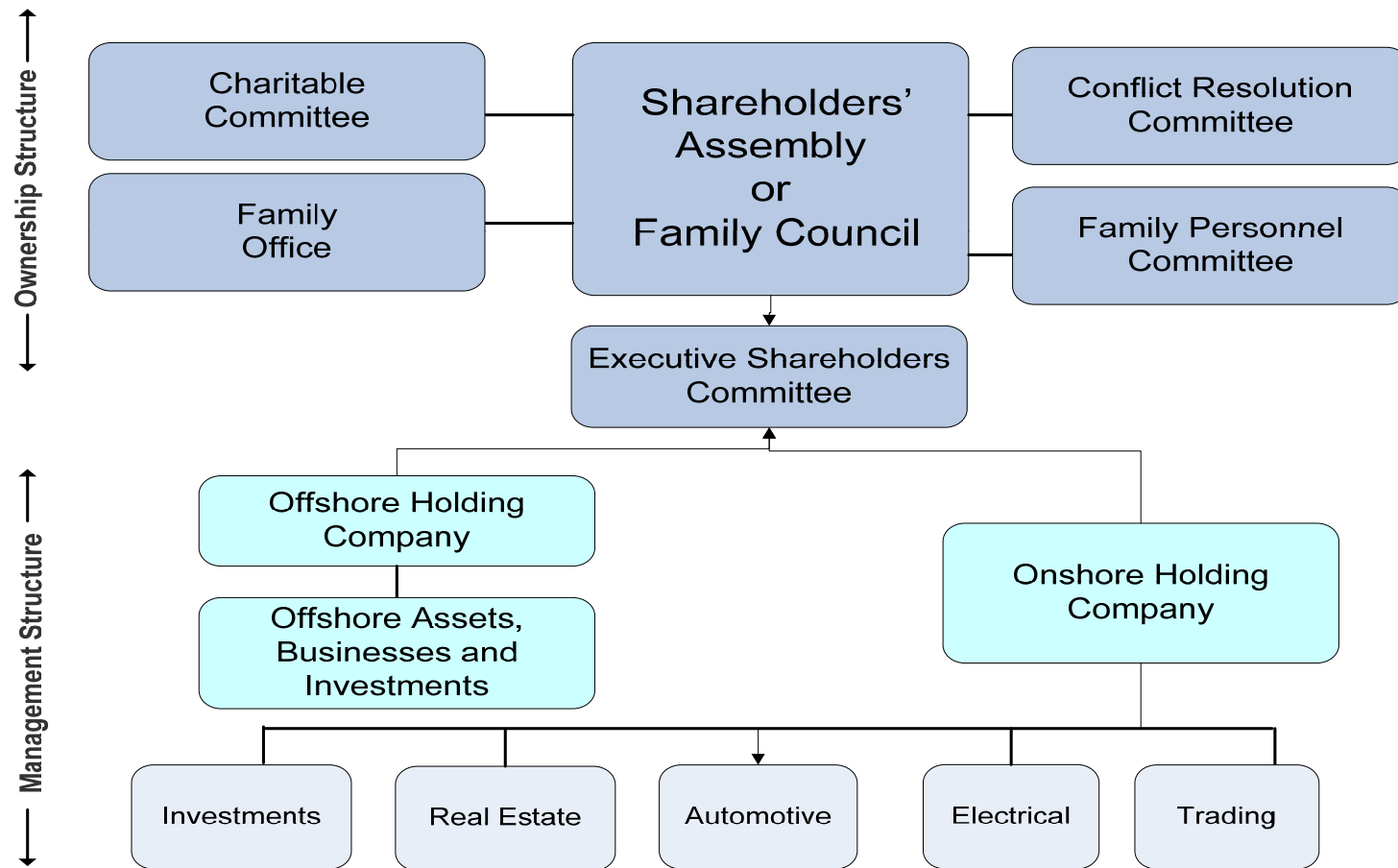
### **A good conflict management framework :**

- protocols provide more clarity
- family conflicts resolved internally

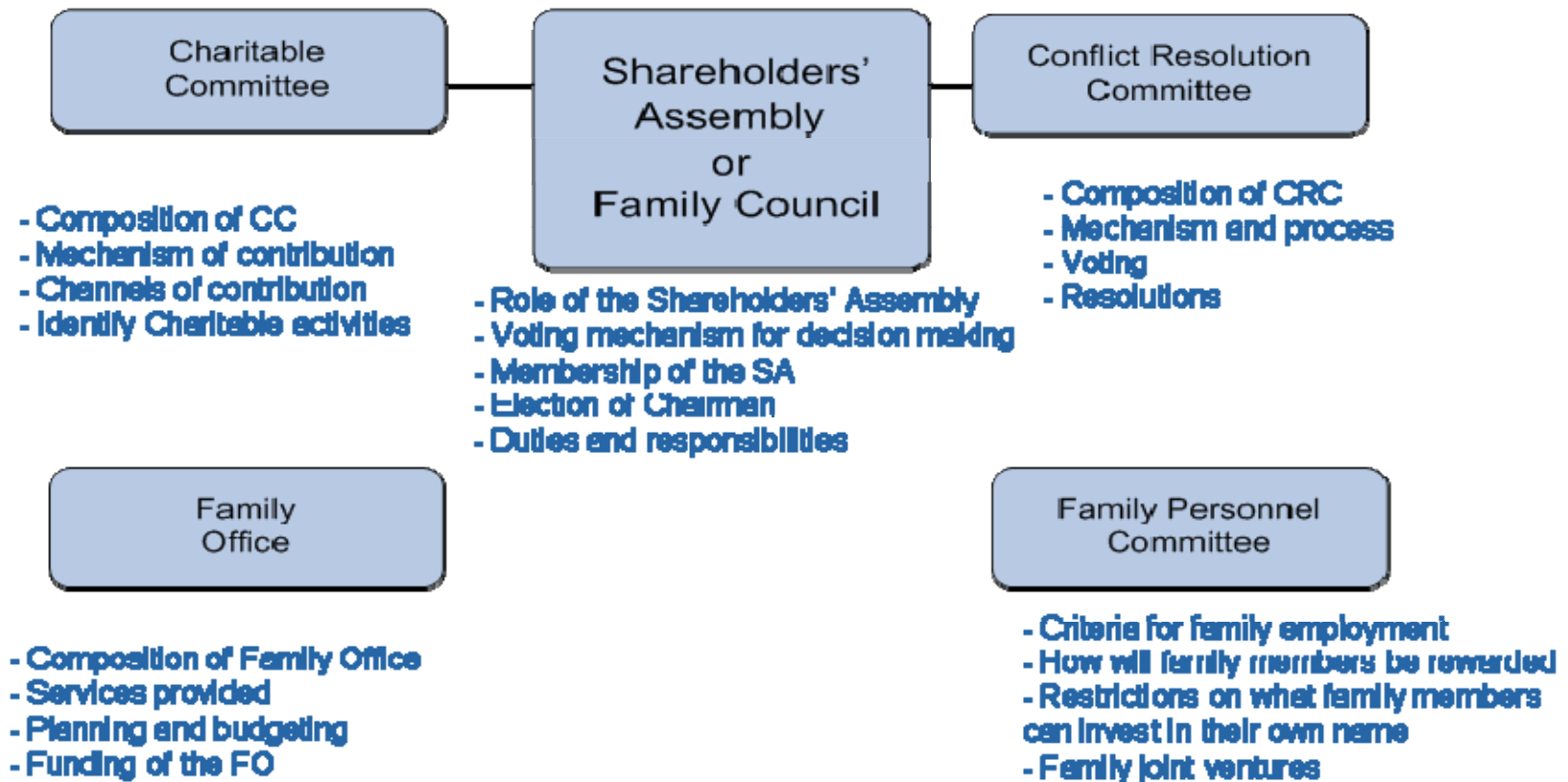
# ***Possible Family Owned Business structure***



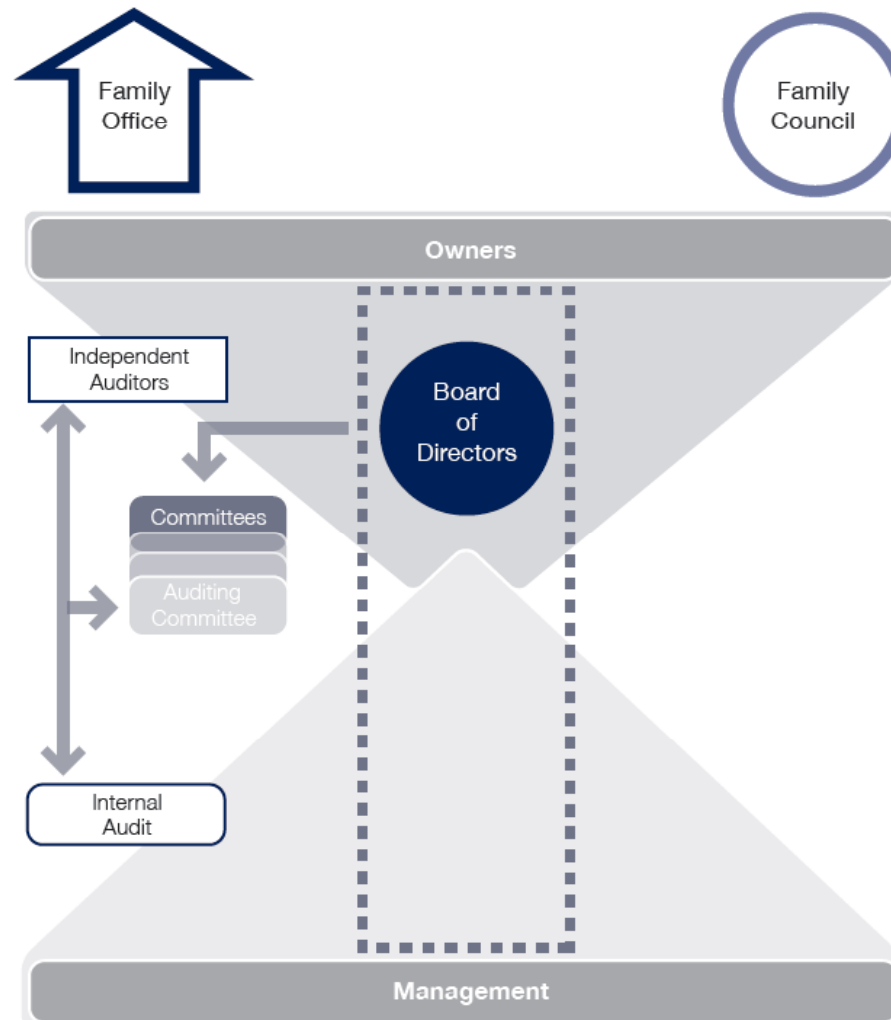
# Possible Family Business structure



# ***Possible Family Business structure***



# ***Possible Family Business structure***



# ***Role of Internal Audit in Governance and Risk Management***

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## ***Challenges facing Internal Audit***

Weaknesses in governance systems of family businesses are most evident in internal controls, internal audit and risk management. Since many family businesses are managed by the founders or their children, the control environment is largely tailored to their needs.

**The problem:** the controls do not grow along with the company, as the business becomes more complex.

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## ***Why Internal Audit matters***

### **Key to good governance – the eyes and ears of the Board**

The four cornerstones of good governance are the **Board, Management, Internal Audit and External Audit**. Faced with increased responsibilities Non-Executive Directors should be looking to Internal Audit to provide proactive support and ensure sufficient information on strategy and risk is provided by executive management on a timely basis.

### **Responsible for auditing all business risk**

In contrast to external audit which focuses on financial statement risks, Internal Audit is responsible for auditing all risks facing the organisation including strategic, operational, information technology and regulatory risks.

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## ***Why Internal Audit matters***

### **Find and escalate critical issues and be heard**

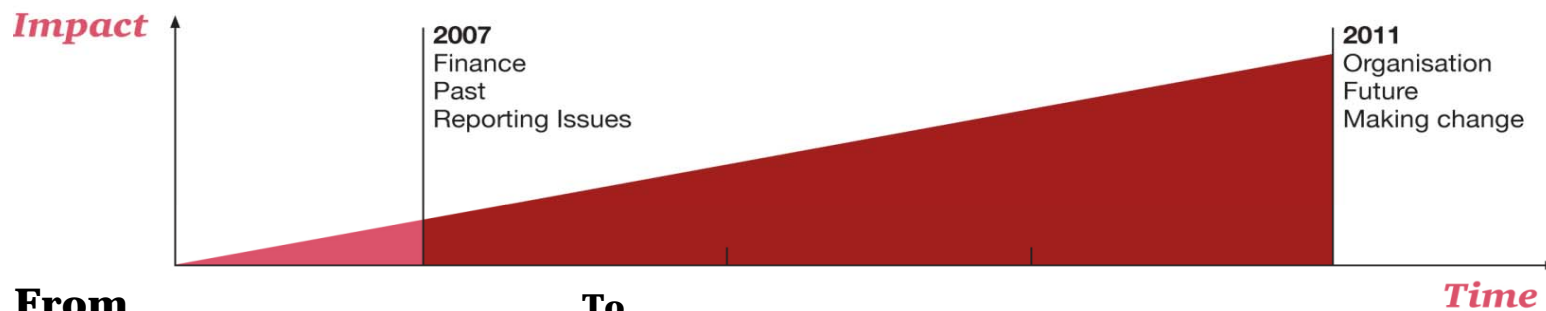
Effective Internal Audit requires enterprise-wide risk assessment and planning and the right number and quality of Internal Auditors to be able to identify critical issues. The Head of Internal Audit has to escalate the right issues and executive management and Non-Executive Directors need to be receptive and supportive.

### **The third line of defence in risk management**

The first line of defence is management's processes and controls, including monitoring controls; the second line is business oversight functions, including risk management, compliance, health and safety; the third line of defence is Internal Audit. No Internal Audit findings means the first and second lines of defence are in place and operating effectively. The extent of Internal Audit procedures at the first and second line is driven by the inherent risk associated with the area subject to review.

## ***Value Proposition***

The value a good Internal Audit creates should be recognized and understood. So we have developed a graphic way of describing the scope Internal Audit can and how it has changed.



### **From**

- Focusing on financial impact.
- Looking at past and current facts.
- Delivering reports on findings.

### **To**

- Looking across the business as a whole.
- Spotting future opportunities and challenges.
- Helping clients develop solutions to implement our recommendations.

### **These shifts mean that Internal Audit function should:**

1. act future-facing
2. enhance value across the organization
3. improve governance and manage risk effectively

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## 1. Future-facing

**The future-facing approach is highlighted when compared to External Audit**

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### External Audit

.....  
Reviews a set of historical financial statements.  
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.....  
Is legally bound to assess compliance of those statements against a rigid set of accounting standards.  
.....

.....  
Has deep understanding of the balance sheet and profit and loss statement.  
.....

.....  
Approach is fixed: review the accounts against the legal standards.  
.....

.....  
Issues an opinion on whether the accounts comply with the standards.  
.....

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### Internal Audit

.....  
Reviews business units and processes across the organization.  
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.....  
Can assess what we see against a variety of standards: the Internal Auditors standards, market knowledge, prior experience etc.  
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.....  
Has deep understanding of the business as a whole.  
.....

.....  
Approach is flexible: hypothesis based, constrained only by own skills, imagination and the charter for the work  
.....

.....  
Delivers insights and foresights into the future of the business, makes recommendations on how best to face that future, and implements solutions where required to help build that future.  
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## 2. Enhance Value

### An explanation

Value may sound generic, but it's not. The value that one person or organization is looking to create, that we can help them create, depends on their precise circumstances.

We work with clients to understand their precise opportunities and challenges (individually and as an organization).

To better understand what value they are looking for and establish how Internal Audit can enhance that value .

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### Three broad categories of value

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Categories of value that we can help to deliver for clients (further details on the next slide).

1. Quality assurance
  2. Improving the business
  3. Finding real dollars
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## 2. Enhance Value (cont'd)

### Three broad categories in more detail

#### 1. Quality assurance

The Board gets the:

- knowledge and confidence that nothing is going, or is going to go, wrong
- ability to rely on the information they get from the organization
- confidence in the smooth operations of the business.

#### 2. Improving the business

Business managers get:

- efficient systems and processes
- recommendations to improve performance
- a different perspective that enables them to make positive change.

#### 3. Finding real dollars

The business gets real financial advantage e.g.

- rebates uncovered and realized
- costs savings through automation
- increased revenue from opportunity spotted and grabbed.

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## 3. Improve Governance and Manage Risk

### An explanation

Following the financial crisis, organizations (at board level in particular) are feeling a greater weight of responsibility to improve governance and manage risk effectively across the organization.

### Internal Audit role

We have a variety of roles to play to help them meet those expectations effectively and with confidence (see more details on next page):

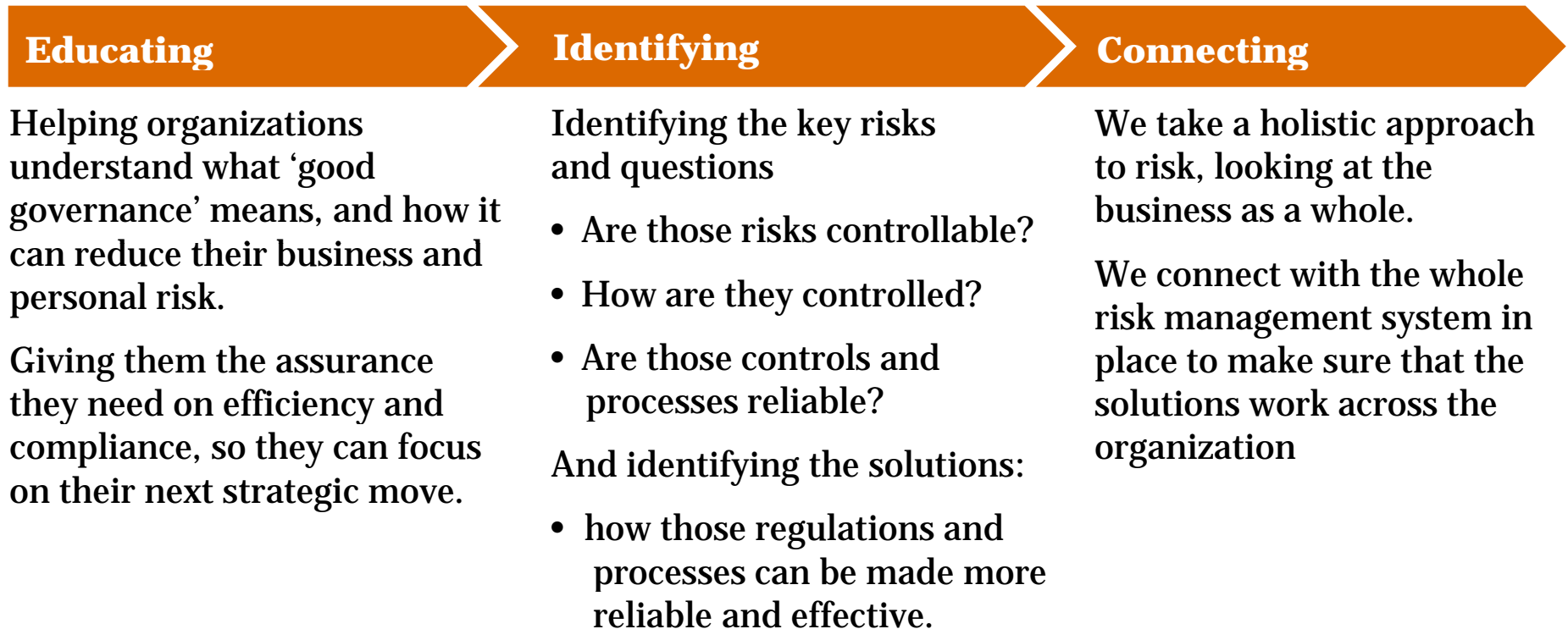
- educating
- identifying
- connecting.

### Measuring results

The best indicator that our work has been effective is that nothing bad happens. But tangible results are key to prove our worth. So, we should develop a tool to help us quantify the impact we have, looking at the risk profile of a organization at a point in time and measure our impact against that profile.

### 3. Improve Governance and Manage Risk (cont'd)

#### Our role in more detail





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