Relevance and use of Internal Audit Function in Family Business

FAMILY GOVERNANCE ASSOCIATES

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Family business combine strengths and weaknesses

- Strengths
  - Commitment and dedication of family as long term owners
  - Knowledge and continuity through passing experience to next generation
  - Reliability and pride as family name, reputation and pride associated with the business and its products/services
  - Quick decision making and ability to react quickly in critical matters including potentially in finance and deployment of resources
- Weaknesses
  - Informal management structures
  - Potentially ineffective oversight and control mechanisms
  - Misalignment of incentives between family members resulting in family conflicts (e.g. family members active in the business Vs passive shareholders)
  - Potential lack of discipline in absence of formal governance

Source of strength also source of weakness

- Fewer or no formal policies and procedures affecting decision-making

$\Rightarrow$Potential source of weakness through lack of discipline and ineffective oversight and control mechanisms

$\Rightarrow$Potential source of strength through speedy decision-making and ability to react quickly to critical matters

- Owners actively involved in management

$\Rightarrow$Source of strength as family members willing to work harder and reinvest profits into the business for long term growth

$\Rightarrow$Source of potential weakness as “agency” costs considered minimal leading to informal management structures and lack of control mechanisms

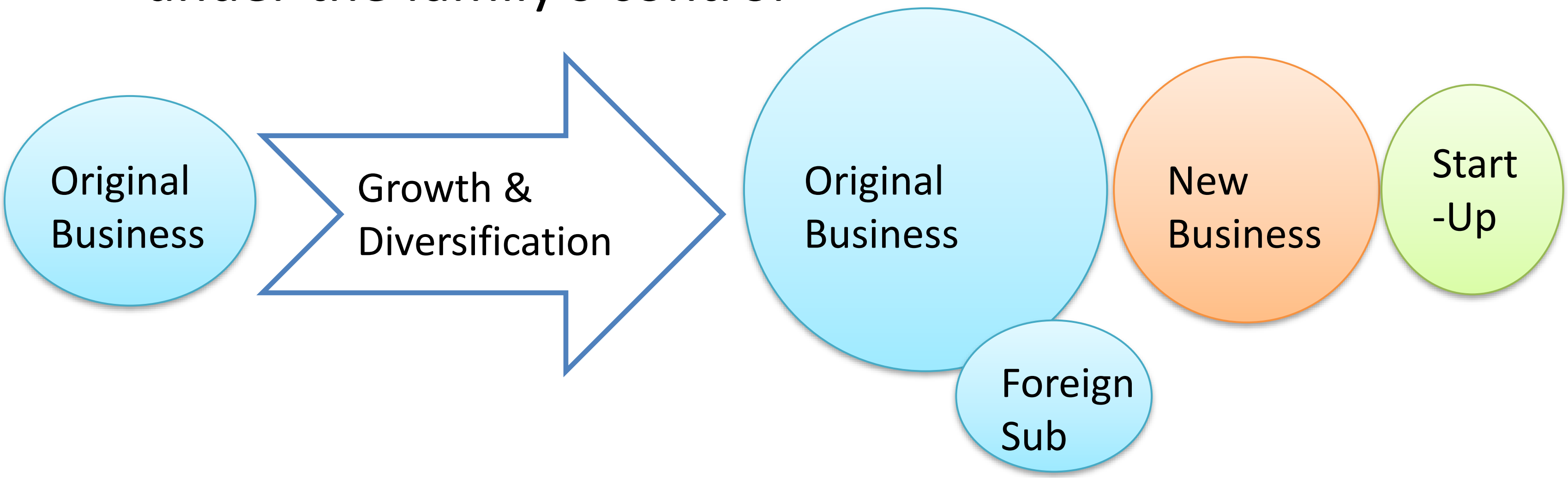
Critical challenge for family business is securing its longevity

Securing longevity requires attention to :

- Continuity planning
  - What is the family philosophy and how it affects the business ?
  - Is there a common commitment and common vision ?
- Succession planning and generational change
  - Transition from being managing owner(s) to being governing owner(s) and professionalizing management
  - Leadership and transitional rules to ensure continuity
- Family governance
  - Establish rules of family engagement with the business
  - Provide forum and mechanisms to deal with diverging interests, potential conflict(s) and minimize their impact on the family business

Professionalizing management as business evolves is often desirable

- As family's interests grow and diversify, management challenges increase and family members may not be best suited for all aspects of management for all businesses under the family's control



- Utilizing non-family members to in senior management can be a smart way to access wider pool of talent and manage a larger and more complex business

Professionalizing management creates agency risks and costs

- Managers are “agents” for the owners and are meant to serve the owners’ interests as they discharge their duties as managers
- Managers placed in control of business activities create an asymmetry of information with owners (i.e. managers have more information than owners)
- Asymmetry of information requires owners to monitor managers effectively to ensure managers are indeed appropriately serving the interests of the owners

$\Rightarrow$ Managers who are now owners create <u>agency risk/costs</u> in case they do not serve the owners’ interests

$\Rightarrow$ As agency risks/costs increase, internal monitoring of managers in order to minimize these risks/costs becomes very important

Internal audit, as part of corporate governance aims to reduce agency risk and agency costs

- Corporate governance does seek to reduce agency risks at reasonable cost
- Cornerstones of good governance comprise
  - Board – which oversees management and is answerable to owners
  - Management – which oversees operations and is answerable to board
  - Internal Audit – which acts as safeguard for the collection of timely and sufficient information by the Board especially in respect of risk(s) affecting the business
  - External Audit – which ensures integrity of financial reporting for the benefit of owners and other stakeholders and is answerable to board

Internal audit is integral part of risk management

- Internal audit function is often likened to “eyes and ears” of the board
- Internal audit’s main value added role is to find and escalate critical issues to be heard at the Board
  - Internal audit must be answerable to the Board and not the executive management
  - Effective internal audit requires enterprise-wide risk assessment and planning to be able to identify critical issues that can affect the business
- Internal audit can be considered the third line of defence in risk management
  - First line of defence is management’s processes and controls including monitoring controls
  - Second line of defence is business oversight functions, including risk management, compliance, health and safety
  - Internal audit checks on the first two lines of defence to make sure they are effective

  $\Rightarrow$ No internal audit findings suggests first and second line of defence are in place and operating effectively

The role of internal audit is evolving to be more future facing and broad

Historically internal audit has been focusing on

- Financial impact of actions/omissions
- Looking at past and current facts
- Delivering reports on findings on what went/may go wrong based on status quo

Evolution of internal audit to include

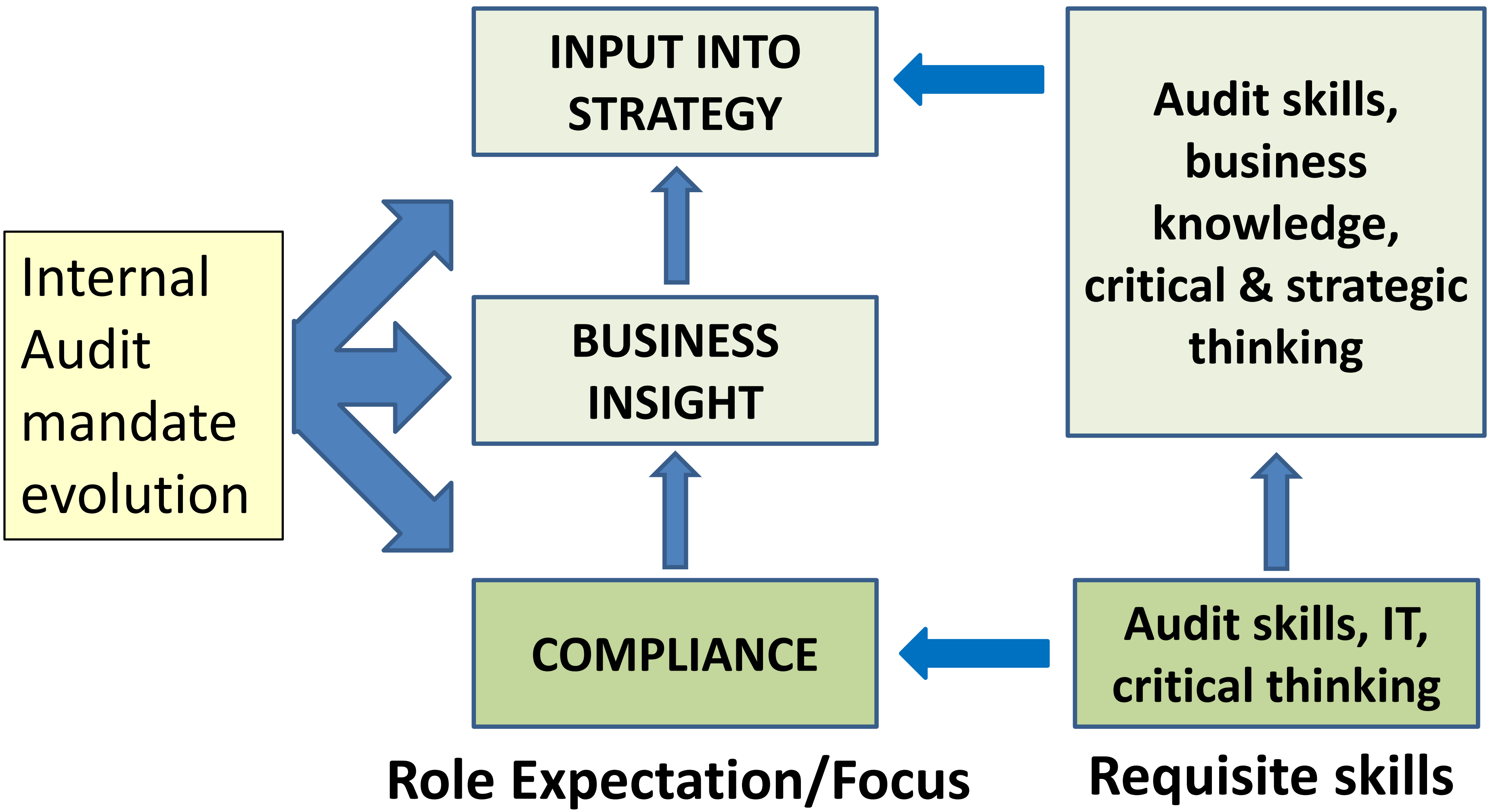
- Looking across the business as a whole
- Spotting future opportunities and challenges

$\Rightarrow$Internal audit function is becoming more future facing

Internal audit mandate is broadening to reflect broader range of risks monitored

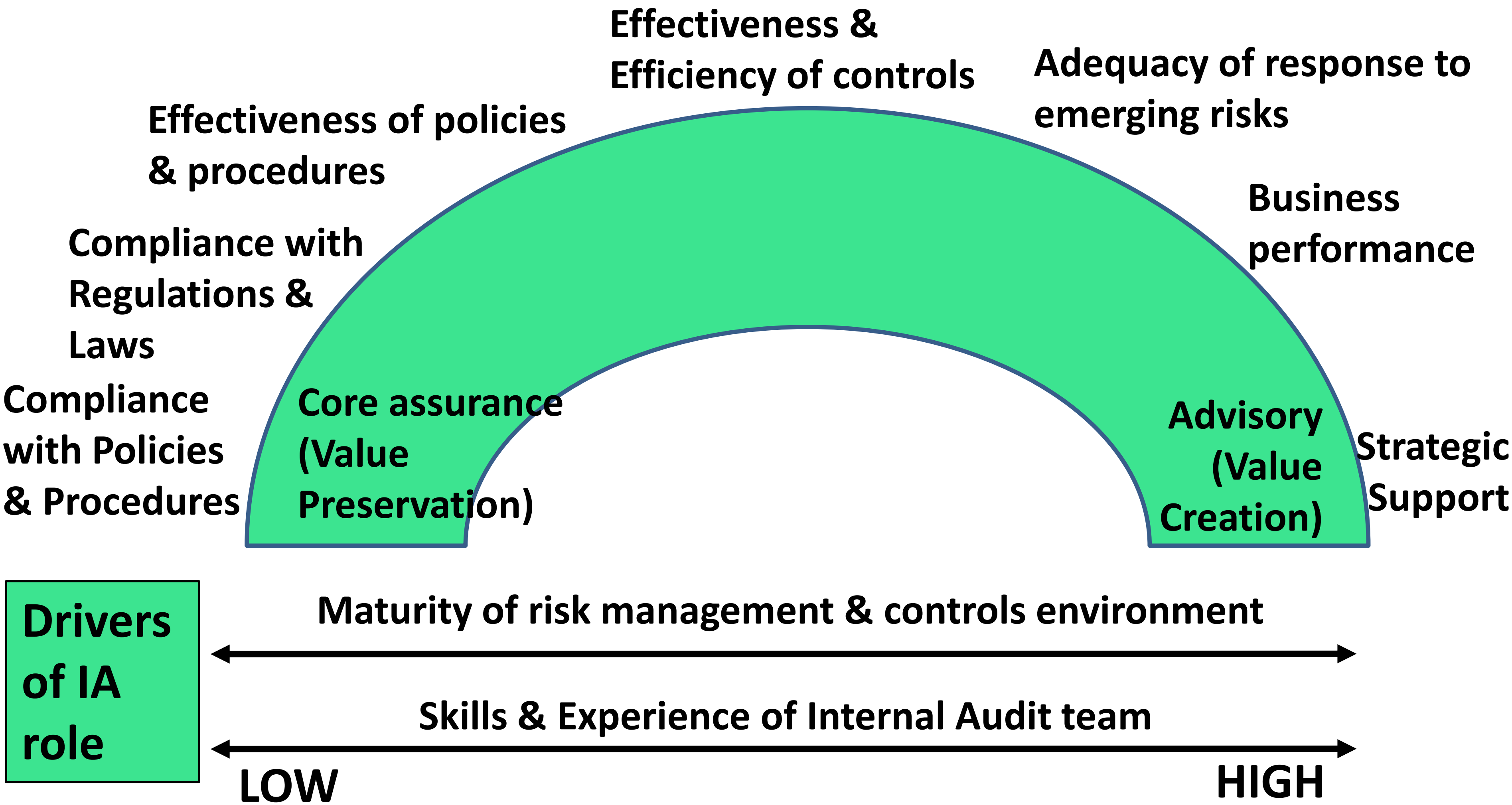
Traditional risks associated with Internal Audit mandate	Emerging risks under broader Internal Audit mandate
Economic stability	Cybersecurity
Major shift in technology and competitor innovation	Data privacy regulations and compliance
Strategic transactions (e.g. M&A, divestitures)	Social media
Emerging market risks and sovereign risk	Climate change
Customer preferences	Sustainability

The broader internal audit mandate transforms the role and skills of internal auditors beyond compliance



What is accomplished by internal audit reflects company circumstances and unit capabilities

Overview of potential roles and range of input internal audit can provide



Internal audit and external audit are complementary and cannot substitute each other

EXTERNAL AUDIT	INTERNAL AUDIT
Reviews a set of historical financial statements	Reviews business units and processes across the organization
Is legally bound to assess compliance of those statements against a rigid set of accounting standards	Can assess against a variety of standards including Internal Auditors standards, market knowledge, prior experience, standards set by Board, etc.
Has deep understanding of the financial statements	Has deep understanding of the business as a whole
Approach is fixed as review of accounts is against legal requirements	Approach is flexible and hypothesis based constrained only by the auditor's skills, imagination and charter for work
Issues opinion on whether the accounts comply with the standards and possible recommendations on shortcomings of accounting/audit procedures/processess	Can deliver 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

Factors anticipated to affect use of IAF (1)

- Positively associated with the company size.
  - Loss of direct control by principals is more likely to occur in large firms increased size and as it becomes more difficult for the owners to oversee the enterprise, there is a greater demand for auditing to compensate for the loss of control
  - the marginal cost of providing an audit decreases with firm size and larger firms have opportunities to take advantage of economies of scale from investing in the fixed costs of internal auditing, which include staff training
- Positively associated with the complexity of firm's business structure
  - More complex (decentralized) firms are more likely to have information asymmetry problems which need strong monitoring mechanisms.
  - Companies where the activities to be controlled are complex, the employment of internal auditors may be a more cost-efficient contractual mechanism to prevent agent's inappropriate behaviour, and report on how well performance meets expectations

Factors anticipated to affect use of IAF (2)

- Positively associated with the level of risks
  - Companies with high levels of accounts receivables, inventories, and cash flows from operations are more likely to have higher internal agency costs in terms of material misstatements in their financial reports as a result of inappropriate behaviors such as assets theft, and intentional and unintentional misrepresentation of information
- Positively associated with the level of debt in a firm's capital
  - Long-term creditors may require companies to have more monitoring activities over their operations as a way to decrease credit risks
- Negatively associated with the proportion of directors' shareholdings in the firm
  - Agency risks/costs are expected to be higher when senior management shareholdings are proportionately lower because of the lower alignment of shareholders and management
  - Internal audit is associated with lower directors' shareholdings to eliminate this agency problem

Factors anticipated to affect use of IAF (3)

- Negatively associated with the percentage of major shareholders
  - Agency costs are expected to be higher when there is a smaller concentration of large shareholders as large shareholders can more directly monitor the activities of management and have the power to affect managers' decisions. Thus, companies with lower proportion of major shareholders are more likely to use an internal audit function reduce the agency problem.
- Positively associated with the existence of an independent chairman and with the proportion of independent directors on the board.
  - Internal audit is more likely to be a complementary governance mechanism in order to reduce information asymmetry problem between executive and independent directors
  - Independent chairman and independent directors more likely to require use of internal audit as safeguard for their own reputation in addition to the benefits to the business

Factors anticipated to affect use of IAF (4)

- Positively associated with the existence of an effective audit committee.
  - The goals of both internal audit and the audit committee are closely intertwined and an effective internal audit function can enhance the effectiveness of the audit committee and vice versa
- The use of IAF is associated with using “Big 4” external auditor
  - Big 4 often offer assistance in setting up internal audit function and position it as an investment by the enterprise in keeping external audit fees lower
- The use of IAF is associated with the proportion of audit fee
  - Internal and external audit are essentially complementary mechanisms to increase the overall monitoring and larger external audit fees can encourage creation and greater use of internal audit function

UK studies show specific factors drive use of IAF

- UK studies confirmed the influence of all factors anticipated to drive use of Internal Audit Function
- UK studies highlighted specific factors as being more influential in driving greater use of Internal Audit Function comprising :
  - Greater company's size as measured by total assets
  - Higher levels of risk
    - Receivables and inventories percentage
    - Operating Cashflows percentage
  - Higher external agency costs as reflected by lower Directors' shareholdings
  - Existence of audit committee

Desirability of internal audit function depends on family ownership stage

- As owners transition from owner-managers to governing owners and corporate governance is introduced, internal audit function becomes more desirable and necessary