The Functioning of the Audit Committee in Family-owned Companies

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Family Owned Company- What Is Special?

More than 75 per cent of large listed Indian companies are family-owned?
Family shareholding in these companies is significant (30 per cent upwards)?
The balance is largely public sector units or subsidiaries of multinational companies?
Companies where the management has little or no stake in the company constitute less than 5 per cent of the large, listed companies.
-Rahul Bajaj in business standard.

The Global Picture

Over 85% of businesses in the European union and USA are family-run.
In Italy the figure is as high as 99%.
40% of the US S&P 500 are family-run firms.

Implications of Family Ownership-according to Family

Family can be assumed to take long term view- spanning future generations.
Owners often pursue contrarian strategies rather than those suggested by conventional wisdom
Relinquishing stakes is difficult- makes them more committed.
Family owners realise that market can be punishing and hence will do nothing to sully their reputation.
What is good for the majority can not be bad for the minority- (remember preferential issues of yester decades!).
Corporate governance is a western idea- relevant only in the context of divorce between ownership and management.

Reality Check on Family Owned Companies

Conflict situations between family interests and minority shareholders interests abound. For eg:
Pricing of preferential issues.
Dividend decisions.
Conflict between family owners and other stakeholders eg: depositors.
Lack of adequate exposure for one family.
Enrichment of one branch of family in management control at the expense of others.
Family succession deciding management succession.

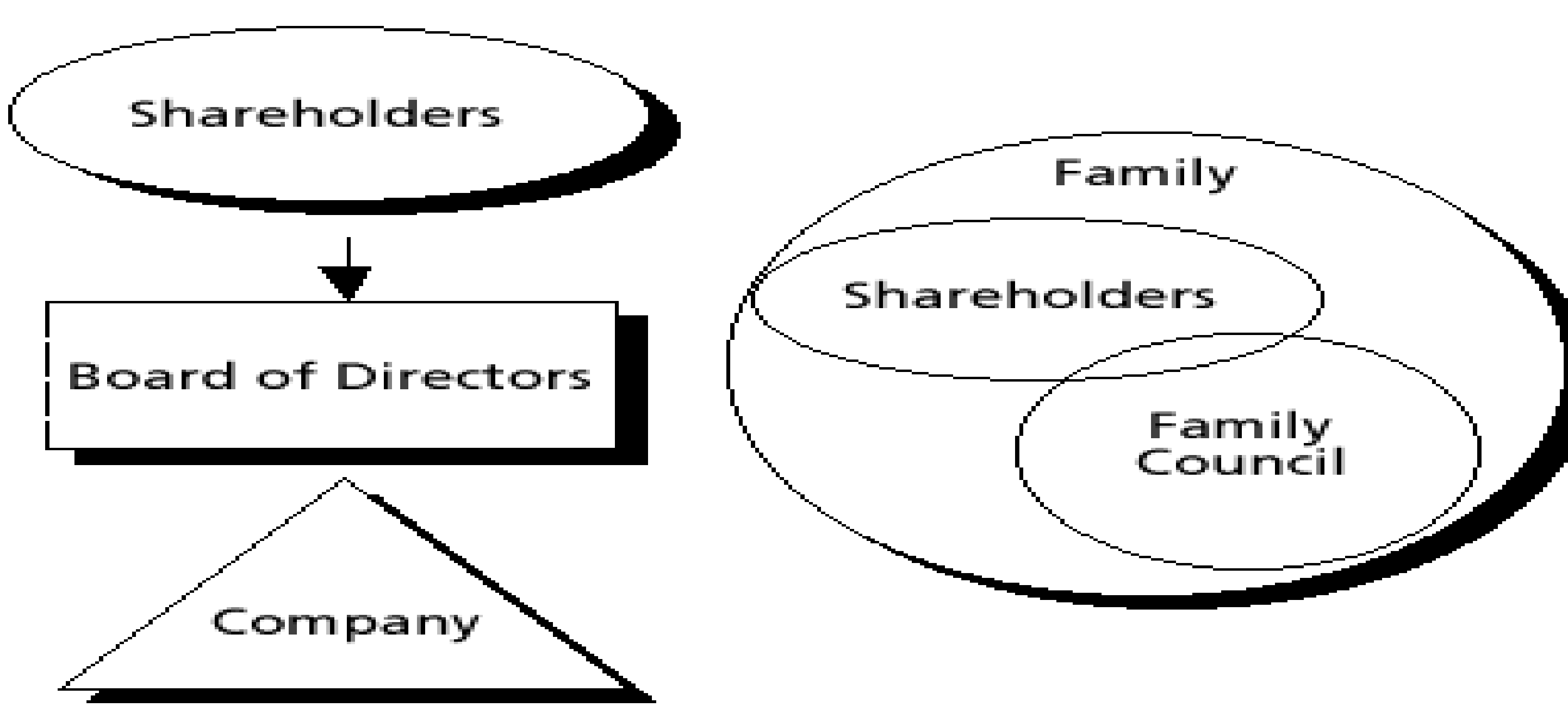
Role of Independent Directors in Family Owned Companies

None or enhanced as compared to western countries?
Popular view is none!
Conflicts between family owners' interests and minority shareholders' interests or other stakeholders' interests can only be resolved by regulation. Independent director should monitor compliance.
Unjust enrichment by one branch of the family must be resolved by family councils (see slide).
Independent director will be well advised not to meddle in family conflicts.
Instead he should play a proactive role in setting up family arrangements for avoiding conflicts and for resolving them.(See slide).
If he finds that the family management is inclined to violate the law, the best course is to resign!. Beware of the extended liability of the director!

Corporate Governance and the Family Business

"The separation of the church and the state."
The family council sets policy for the family and recommends policy that concerns the family to the board (e.G. Policy about family employment in the business).
The board of directors sets policy for the business and may also make recommendations to the family council in matters that concern the business.
These board and family council will ideally coordinate their work but not overstep into each other's domains.
(*Governing the family business john Davis HBS).*

The Family Business- Relationships Among Governance Structures (*Davis*)



Family Council Et Al

Family council consisting of father, mother, sons, sons-in-law, daughter, daughters-in –laws. Meet once in two months to keep the family together.
Family board (men only!) To review the business, look at future growth plans and direction for the group.
Non-family business board (women only!) To maintain the emotional bonds in the family.
Servant leaders to focus on building an emotional bond with the entire family and resolve tensions.
The Family Constitution

- Succession plans.
- Qualifications of family members to enter business (have they to be management graduates?).
- Their remuneration and perks (including the car they will get to drive!).
- How to take care of those who want to opt out of the family business.

-About the GMR family in the business standard.

The Scenario for the Audit Committee in the family owned companies

Is Earnings management more or less in family owned companies than in publicly owned?
Are the promoters aware of the extent of adherence to accounting standards-especially where management is divorced?
Is there a clear role for the audit committee in the key area of monitoring earnings management?
Family-owned companies often tend to have "family auditors" akin to family doctor or family lawyer?
Where is the role then for the audit committee to recommend appointment or fixation of fees?
Not to speak of removal!

The Audit Committee and the auditor

The subsisting role of the Audit Committee in family managed companies is in the matter of reviewing the quality of audit.
The Committee will review the audit plan, scope and coverage, audit methodology and adherence to auditing standards.
Starting with review of internal controls.
Goes beyond to Risk assessment.
Areas where the family may not have competence, yet areas requiring attention.

How Good Is Your Audit Committee?

1. Recognize that the dynamics of each company, board, and audit committee are unique—one size does not fit all.So for family owned companies.
2. The board must ensure the audit committee comprises the “right” individuals to provide independent and objective oversight.
3. The board and audit committee must continually assert that and assess whether, the “tone at the top” embodies insistence on integrity and accuracy in financial reporting.
4. The audit committee must demand and continually reinforce the “direct responsibility” of the external auditor to the board and audit committee as representatives of the shareholders.
5. Audit committees must implement a process that supports their understanding and monitoring of.
    a. The specific role of the audit committee in relation to the specific roles of the other participants in the financial reporting process (oversight).
    b. Critical financial reporting risks.
    c. Effectiveness of financial reporting controls.
    d. Independence, accountability, and effectiveness of the external auditor.
    e. Transparency of financial reporting.

ACI’s *Basic Principles for Audit Committees*