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For Family Businesses, Strong Governance Is The Secret To Managing Risk

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I write about entrepreneurs' exit strategies, ESOPs and M&A.

In my experience, family-owned businesses generally view governance like castor oil: While it must be swallowed to keep you healthy, it's still unpleasant. For many owners of family businesses, governance and risk management seem more of an issue for their larger counterparts like Cargill, Kohler and S. C. Johnson, global giants held accountable to a wide array of stakeholders.

A frequent comment by family business owners – "We've always done it this way" – goes a long way to explain this casual attitude. But that viewpoint ignores the significant operational and competitive benefits that good governance and strong risk controls can produce, most importantly handing over a healthy and efficient organization to the next generation. Dismissing governance as a priority disregards modern realities, where marketplace disruption reigns and cybercrime and social media snafus can instantly damage corporate value.

Given the potentially catastrophic consequences of a risk management lapse, discounting the importance of sound business governance is penny wise, pound foolish. A study of the chief reasons why Canadian family businesses sour found that poor governance measures dominated. These included poor succession planning, too few trusted third-party advisers, family conflicts and differing visions among generations, ill-prepared next-generation leaders, and poor strategic planning. No wonder just an estimated 12 percent of family businesses remain viable for the third generation to lead, according to the Family Business Alliance. A different survey by Deloitte showed more than 40 percent of family business owners have no succession plan in place.

Given how much is at stake, we have a strong view for family business owners regarding governance and risk management. I generally advise our clients:

Focus first on strong financial controls and cyber security. Beyond having fundamental controls in place like dual-level signing and expense reporting, we advocate strongly for audited financial statements and operating within a pre-set annual budget.

Attention to cyber security is the second requisite. Given the informality and high level of trust with which most family businesses operate, attention to phishing attacks, in which employees receive realistic, but false emails, is particularly important. One scheme we're familiar with asked an employee to purchase $1,000 in iTunes gift cards. While that is almost comical, another phishing attack, which asked an unsuspecting employee to remit several hundred thousand dollars based on a bogus invoice, was far more serious.

Because the consequences can be so grave, we recommend family businesses hire a firm to provide cyber security training and then conduct frequent mock attacks. Given the sophistication of hackers and cyber thieves, professional training is necessary.

Formalize a good governance philosophy, framework and structure. Successful family businesses have typically committed to sound management and transparent decision-making procedures, especially as they relate to treating all owners, as well as non-family executives and other internal talent, fairly and equitably. (In today's talent wars, don't disregard the importance of retaining your best people.)

Begin by creating a strong organizational structure that spells out roles, responsibilities and reporting lines. Then conduct annual governance and risk checkups, much like an annual health exam, and closely consider employee and ethics policies that are easy to take for granted. This is important given the speed of risk oversight and litigation from investors, lenders and other stakeholders. At our firm, Verit Advisors®, we meet informally with our outside counsel each year to provide an update of where we're at and to get their update on trends they're seeing. Last year, we established a sexual harassment policy and in January, again asked every employee to reread and re-sign our ethics policies.

Family business owners should become educated on governance issues. The National Association of Corporate Directors publishes a daily governance email and the major accounting firms issue best-practices bulletins that are easily read. From time to time, we attend workshops and conferences on governance and risk management-related topics that provide helpful information.

Establish a capable, well-functioning board of directors. A private company board is the keystone of good governance, serving as the go-between for the company and the family and a source of external perspectives. Yet, more than one-in-four family-owned businesses don't have a board, the Deloitte survey found, although some have an advisory board or a family council.

The chief value of a board is it can help the family business' CEO see around corners. The board's composition is crucial. While family members will comprise a substantial percentage of the board, and often the majority, the board should have some independent outside members who bring legal and finance, strategic and governance/risk management skills.

Electing independent directors is critical given the changing dynamics of a fiercely competitive marketplace. It pays to assess the skills and talents on the board and gap-fill to acquire the needed expertise. For instance, the owner of one mid-size family business that hadn't had any M&A activity was eager to look strategically at it. Consequently, the company filled a board vacancy with an M&A authority and then expanded the board to nine members with the addition of a director with a private equity background.

For a high-functioning board, we recommend establishing a Risk or Audit committee that contains at least one independent, non-family member. We also recommend larger or multi-generational family businesses establish a Compensation Committee to provide transparency in setting salaries and benefits for family and non-family executives.

A board can help a family business navigate the conflicts of interest that are inevitable as the business grows and becomes more successful. For example, the CEO may wear too many hats, serving, for example, as the fiduciary for the family business' ESOP while setting their own compensation. In this world with multi-generational owners and charitable trusts, it is important to demonstrate the ability to be fair to every shareholder.

Formalize succession planning. Successful family businesses signify years of hard work and dedication. To pass on this success, planning for a successful transition needs to be made part of every family firm's culture.

In particular, clear criteria for selection of the family members who are to lead the business and well-thought out structured governance and transparency for those not directly involved are essential, especially as the family firm navigates into the critical third generation, a time when many family businesses founder. A succession plan allows the company to develop and facilitate leadership changes in a progressive, planned and non-disruptive manner, and will also help maintain an appropriate balance of skills and experience within the company.

My point of view is that regardless of the size and longevity of a family business, sound corporate governance and attention to risk management is in every family business owner's best interests. A good foundation will not only help keep the business out of trouble, it will help provide the insights and retain the talent to power its long-term success.

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I am Founder & CEO of Verit Advisors, a middle market investment banking firm. I have nearly three decades experience with Employee Stock Ownership Plans, and have a... **Read More**