Firm Characteristics Associated with the Investment In Internal Auditing in Family Businesses

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Abstract: Family Businesses are cornerstones of economic growth around the globe. They also face unique governance and internal control challenges related to their unique combination of family and business. The differing levels of proportions and combinations of family and non-family management and shareholders result in differing levels of agency relationships and agency costs, providing numerous scenarios to research. Internal auditing has been identified as a potential solution for the resulting need for monitoring mechanisms. The proposed research will provide a framework that can be used to determine how best to adapt to differing levels of ownership and management.

KEYWORDS: Family business, internal auditing, agency theory, internal controls, governance

INTRODUCTION

Family businesses, in the United States and globally, are the cornerstones to economic growth and improved societal standards of living. Due to their unique combination of family and business, these firms face important governance and internal control challenges. However, despite the importance of these firms there is limited empirical research concentrating on internal controls, especially controls related to internal auditing (Carey, Simnett, & Tanewski, 2000). More specifically, relatively little research has been reported that is associated with the size of the internal auditing function and factors that influence a family business's decision to invest in an internal audit function (Sarens & Abdolmohammadi, 2007; Sarens & De Beelde, 2006). This study will examine certain characteristics of family businesses, their relation to the investment in the internal audit function, and the resulting firm performance. Specifically, utilizing agency theory how does the separation of ownership and management measured by the distribution of management and share ownership between family and nonfamily members, influence the investment in internal audit? Further, is there a correlation between the investment in the internal audit function and firm performance? The answers to these questions can assist family businesses to assess their current risk as well as to understand how to adapt to changes in proportions of family and nonfamily ownership and management distribution.

An agency relationship occurs when the principal, (the owner), delegates authority to another party, (the agent), who is charged with using and controlling those resources (Jensen & Meckling, 1976). This delegation makes it possible for the agent to have more information and

the opportunity to implement decisions that could benefit the agent, but could harm the business and the owner. In response to this threat, the principal often imposes some form of monitoring device(s), which are implemented and maintained at a cost therefore incurring agency costs (Bartholomeusz & Tanewski, 2006; Schulze, Lubatkin, Dino, & Buchholtz, 2001). Adams (1994) examined how agency theory can be used to explain the existence of the internal audit function, including the approach of the internal auditors to their work. Carey, et al., (2000) advanced the research of agency theory related to the voluntary demand for internal and external auditing in family businesses in the unregulated Australian environment. Sarens & Abdolmohammadi (2007) used agency theory to identify the determinants of the size of the internal audit function in Belgian companies.

Jensen & Meckling (1976) posited that agency costs do not apply when a wholly owned firm is managed by the owner because the owner will make decisions that maximize the utility of the business and the owner. Contrary to this earlier opinion that family owned and operated businesses are safe from agency issues related to internal controls, research results have since suggested that family control actually creates situations of agency costs rather than negating them (Bartholomeusz & Tanewski, 2006; Schulze, et al., 2001). Chrisman, et al., (2004) found that sources of agency costs in small, privately held firms can be related to owner-lender conflicts of interest, owner-employee relationships, and problems of altruism. DeFond (1992) and Francis & Wilson (1988) suggested the importance of diffusing or separating ownership and control, while Donnelly & Mulcahy (2008) found voluntary disclosure increases with the number of nonexecutive directors on the board. Corporate governance suggests the importance of control mechanisms to enhance internal decision making that benefits owners as well as other stakeholders. According to the Institute of Internal Auditors (IIA, 1999), "Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organization's operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes." Since 2001 and the large, highly publicized fraud cases of companies such as Enron and WorldCom, The New York Stock Exchange (NYSE) required all listed companies to have an internal audit function by October 31, 2004 (Harrington, 2004). In addition, the implementation of Section 404 of the Sarbanes-Oxley Act has resulted in companies placing more emphasis on internal controls related to financial reporting (Prawitt,

Smith, & Wood, 2009). Prior to 2001, external auditing received the majority of attention. The Institute of Internal Auditors (IIA) wasn't established in the United States until 1941, almost 60 years after the first external audit bodies were established (Spraakman, 1997).

Utilizing the traditional characteristics of firm size, firm debt and the unique measures of a family owned business, (the proportion of nonfamily management in the firm, and the proportion of nonfamily representation on the board of directors), Carey, et al., (2000) supported the hypotheses related to greater separation between ownership and control resulting in increased agency costs. However, the research completed by Carey, et al., (2000) could explain the voluntary demand for external auditing, but not the voluntary demand for internal auditing in family businesses in the unregulated Australian environment. To date, empirical research has not been published on internal auditing in family businesses in the United States or on factors that might impact the decision to implement or maintain internal audit activities. However, there are published studies from Australia (Bartholomeusz & Tanewski, 2006; Carey, et al., 2000), Lebanon (Fahed-Sreih & Djoundourian, 2006), Germany (Pieper, Klein, & Jaskiewicz, 2008), Hong Kong (Ng, 2005), and Indonesia (Achmad, Neilson, & Tower, 2009).

The proposed study extends the research in a number of ways; first by examining the unique family business characteristic of the proportion of nonfamily managerial share ownership. This was recommended by Carey, et al., (2000) as an area for future research to gain greater insight into the voluntary demand for auditing in family businesses. Second, the proportion of nonfamily management in the business included in the Carey, et al., (2000) study will be examined, along with a new variable of percentage of shareholders not involved in the business. Third, the impact of these proportions of ownership and management on the demand for internal auditing will be tested using survey data from the Chief Financial Officers of identified family businesses within the United States. The traditional characteristic of firm size will also be included, as the research conducted by Carey, et al., (2000) in family businesses resulted in a finding that was inconsistent with prior research related to a positive correlation between firm size and the demand for auditing (Abdel-Khalik, 1993; D. Anderson, Francis, & Stokes, 1993; Carcello, Hermanson, & Raghunandan, 2005; Chow, 1982; Daily & Dollinger, 1992)

VARIABLES

The independent variables for this research proposal will be (a) firm size, (b) proportion of nonfamily management in the firm, (c) percentage of shareholders not involved in the

business, and (d) proportion of nonfamily managerial share ownership. The industry will serve as a moderator and the dependent variable will be the investment in internal auditing measured in dollars budgeted/spent. In addition, firm performance data will be gathered to assess the potential correlation with the investment in the internal audit function.

Focusing upon firm size, Carey, et al., (2000) did not find support for the hypothesis that the demand for auditing, either internal or external, was positively correlated with a firm's size. This result was inconsistent with findings from previous empirical research that reviewed the demand for auditing, or some form of formal control system (Abdel-Khalik, 1993; D. Anderson, et al., 1993; Chow, 1982; Daily & Dollinger, 1992). Daily & Dollinger (1992) found a positive and significant relationship between firm size and the use of a formal internal control system. One possible reason for the difference could be the uneven representation of firm size in the data gathered for the Carey, et al., (2000) research with an underrepresentation of small and large sized family businesses. In a study of internal audit budgets in mid-sized public companies in the United States, it was found that the larger the company, the larger the internal audit budget (Carcello, et al., 2005).

As the percentage of shareholders not involved in the business increases, there is a growing concern that the managers could depart from maximizing shareholder wealth (Chow, 1982). Agency theory is based on the premise that principals have less information than agents and this adversely affects the principals' ability to monitor effectively if, in fact, the agents are appropriately serving the interests of the principals (Adams, 1994). Members or shareholders of a family business not actively involved in the business need to have confidence that the management of the business is capable of running the business and adapting to changing business and environmental situations so that the business can flourish (Sundaramurthy, 2008).

Shareholders with a large portion of their wealth in the business have incentives to adopt and enforce governance practices to prevent self-control problems of owners and management from undermining the viability of the firm (Schulze, et al., 2001). Daily & Dollinger (1992) found that the desire to maintain close control, leads family run businesses to use significantly fewer formal internal control systems, instead opting for more social methods of control. However, as the percentage of shareholders increases, the demand for monitoring systems will also increase. As family members retire or subsequent generations are not interested in pursuing the family business, the business may move closer to a market model of fewer active family

members, resulting in the need for control mechanisms to sustain the business (Lane, Astrachan, Keyt, & McMillan, 2006). An internal audit function of high-quality can provide greater monitoring and therefore greater transparency to any potential bias in management's decision making (Prawitt, et al., 2009).

Lastly, in non-family businesses, a manager that is also a shareholder typically has only a small portion of the firm's equity shares and therefore may have incentives to allocate resources that are not consistent with the interests of the non-managing shareholders. Anderson and Reeb (2003) focused upon the proportion of nonfamily management in the firm, and found there are strong incentives for families to monitor managers because the family's wealth is so closely linked to the firm's welfare. From the shareholders' perspective, agency theory would suggest that the greater the amount of non-family managers, the greater the need for monitoring. From the non-family manager's perspective, agency theory would suggest that the greater the ownership share of the non-family manager, the lower the need for monitoring. Jensen and Meckling (1976) found that as the manager's ownership increases and the manager is more impacted by the costs of his or her actions, the tendency to take personal advantage of the management situation decreases. Therefore the greater the ownership of the non-family manager, the more closely the objectives are aligned with the family and with shareholders (DeFond, 1992).

METHODS

The impact of these characteristics on the demand for internal auditing will be tested using survey data gathered from the Chief Financial Officers of identified family businesses within the United States. Follow-up research will focus on family businesses in Europe. Eventually, a model could be created to test family business characteristics associated with investment decisions influencing the internal audit function and the related firm performance.

IMPLICATIONS

Family businesses offer a rich research opportunity to examine different aspects and dynamics of the separation of ownership and management. The unique characteristics of the family and the multiple and changing levels of family involvement in the business provide numerous scenarios to research. The differing levels of proportions and combinations of family and non-family management and shareholders result in differing levels of agency relationships and agency costs. Internal auditing has been identified as a potential solution for the resulting

need for monitoring mechanisms (Abdel-Khalik, 1993; Adams, 1994; Carey, et al., 2000; Goodwin-Stewart & Kent, 2006).

In conclusion, academically the study addresses a major gap indentified in the literature related to the investment in internal auditing by family businesses. For practitioners the study will provide much needed information for owners, stakeholders, and managers to determine if internal auditing activities are the appropriate monitoring mechanisms to reduce agency costs and to reduce the separation between ownership and management. The research will provide a framework that can be used to determine how best to adapt to differing levels of ownership and management.

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