POOR RISK MANAGEMENT CAN SINK A FAMILY BUSINESS

Many firms lack controls for cyberattacks, fraud

BY JEFF BUCKSTEIN

ALTHOUGH FAMILY RUN enterprises tend to be carefully nurtured by their founders, many of whom treat the business as a labour of love, they face a potential blind spot which could prove to be a fatal flaw. Many entrepreneurs don't conduct a proper risk assessment to evaluate and strategize against serious threats like cyberattacks, which could leave them vulnerable to losing everything they've built.

“It's one of those things that you don’t think is going to happen to you right now — that there’ll be a failure of some sort, or a crisis. So you put that off because there are always other places that money needs to go,” said Robin-Lee Norris, a partner with the law firm Miller Thomson LLP in Guelph.

“The problem is it’s very often too late to do it when there’s the need, and [then] you can’t fix it,” she warned.

A study by New York based Crystal & Company of 159 private family run enterprises — including family offices, operating companies and holding companies across the United States in 2014 — illustrated the problem.

It reported that that “while 66 per cent of participants ‘strongly agree’ or ‘agree’ that strategic risk management objectives are determined at the highest levels of the family enterprise, only three out of 10 have implemented a risk management review process that includes risks to the family itself.”

A couple of reasons were uncovered as part of a follow-on review of the survey results, said Linda Bourn, executive managing director of Crystal & Company’s family enterprise risk practice.

“They typically don’t have a full-time risk manager. Private family held companies may have the risk management role assigned to an executive group [or] a CFO or COO who are already tackling other types of financial operation or regulatory issues. And so planning around risk tends to be at a corporate level, and planning around the family owners themselves tends to be at a personal level, or elsewhere,” she said.

The family owner should be a participant in their own risk management plan as part of their overall annual financial planning process, Bourn stressed.

“The other thing we learned is that because of the complex structure of family holdings — because they oftentimes have multiple corporate entities, trusts or partnerships as an example, that can make it very challenging to address
risk across the whole enterprise,” Bourn noted.

Rob Torok, a co-founder and partner in BetterVu, a Toronto-based firm focused on performance and risk management, said some founders/owners of family firms believe they have a handle on risk management by virtue of their knowledge of the business.

“They see risk management as ‘I know my customers. I know my suppliers. I know my plant.’ What they don’t have is an enterprise view of risk where … they understand the risks of the organization. So the smaller, privately held family enterprises will typically have very informal risk management processes,” added Torok, an adviser on risk management to CPA Canada.

Norris said many family businesses don’t do a risk analysis until they are forced to when borrowing money from lenders such as banks and credit unions. Financial institutions, as part of their pre-lending due diligence, assess whether that business has the proper risk management protocols in place.

“They find themselves a bit shocked to learn they can’t get their financing unless they go through a risk analysis and provide that information,” said Norris.

Family offices face several key risks, as do other private and public entities. These include the potential for cyberattack, becoming the victim of financial fraud and loss of reputation [which can also be a byproduct of other failures].

In fact, for family businesses, reputational risk is often considered more important than financial risk because the family name is at stake, said Michelle Osry, who heads up Deloitte Canada’s business family advisory practice in Vancouver.

Perhaps the most feared risk in 2016 is to protect that data,” said Torok.

The effect can be devastating. A family owned business, especially a smaller one that is closely held, can represent an investment that the entrepreneurs and their families have their whole lives tied up in.

“You’re talking about something that could close a business and put an entire family out of work. It’s also the business that will fund their retirement. The business gets sold, and the money from the sale is what people retire on. And so when you have all your eggs in that one basket, failure to plan and have a risk management strategy literally could destroy your financial life and create huge difficulties between family members,” Norris warned.

A cybersecurity violation for a family run enterprise can also be particularly harmful personally. Norris said she has seen situations where some small business owners don’t properly separate their personal and business lives.

“Because they are so overlapped they are using the business IT for all their personal use without doing the kinds of safeguards that they should. Somebody can hack into your company and they’re into all your personal stuff as well,” she warned.

In fact, noted Bourn, many family offices that participated in the Crystal & Company study, even those with strong controls in place, said they had experienced fraud because the e-mail of a family member was hacked.

Another potential risk leading to a serious vulnerability is that many small family businesses are based on personal relationships, which decreases the chance that there will be a critical, arm’s-length second pair of eyes available to watch over the financial transactions and spot dishonesty or incompetence.

“You could find your business — and I have gone through that with clients before — completely taken down by trusting someone who mismanages the finances,” said Norris. “Doesn’t pay bills. Doesn’t keep the records complete. And if it’s at a time when you’re going through some change or financial tightening, it can literally result in the doors closing, or being sold as a fire sale to someone who could put cash in,” she added.

Osry had a similar viewpoint.

“Family offices tend to be more exposed to fraud because there are typically fewer internal controls, as compared to independently run companies, little or no segregation of duties, and little or no oversight of those managing the bookkeeping and cash flow functions. This occurs as family offices tend to rely on long-term employees who take on more than one role,” she said.
Lack of adequate risk management can also affect the value of the business because if potential buyers from outside the family realize this aspect of business has been ignored, this will likely raise questions about whether due diligence has failed in other areas too, say experts.

“If they see you haven’t done any risk assessment — you don’t have risk plans in place in the various categories that would apply to that company, two things could happen — and I’ve seen both of them. One is they are not prepared to buy your shares. They only want to buy the assets of the business. Secondly they will lowball. Because the more risk they think they’re assuming the less they’ll pay you,” said Norris.

Nathalie Boutet, principal of Boutet Family Law in Toronto, points to another major risk in family run enterprises that she claims is often overlooked, and that is the danger that interpersonal relationships will be damaged, taking the business down with it.

“It’s called relationship risk. When people don’t take care of their relationship, whatever plans they put in place are not going to work,” she warned, citing as an example the high rate of divorce in Canada, which can impact the survival of a family business.

Experts suggest there are several best practices that a family enterprise can adopt with respect to risk management.

Advanced planning for the occurrence of a risk event, such as having a backup facility, keeping additional inventory and understanding not only the workings of their immediate supply chain, but also their supplier’s suppliers, can go a long way toward preparing a business for supply shocks and disruptions from a major catastrophe such as an earthquake, said Torok.

Boutet said professionals who work with family enterprises need to place more emphasis on the quality of personal relationships. It can be relatively easy for experts to provide advice on issues related to saving money or insurance. But in a family run business, it is also important to address key personal issues involving family members and their respective roles, because dissension can tear apart the family and destroy future plans for the business.

Bourn said some larger family offices and businesses are establishing a private family trust company to formalize the succession of trustees and to eliminate the liability of family members being named individually as a co-trustee. This approach professionalizes the decision-making process on family assets, she explained.

Family enterprises that performed well in the Crystal & Company study established risk management processes that spanned the entire organization and made sure that strategy remained active.

“They also test their planning. They don’t throw it in a drawer, but think of it as something they need to do annually or semi-annually as part of their process for continually updating,” Bourn said.