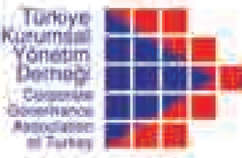

Corporate Governance Association
Of Turkey Publications

Governance Guide for Family Companies

"IN THE LIGHT OF CORPORATE GOVERNANCE PRINCIPLES"

Governance Guide for Family-Owned Companies

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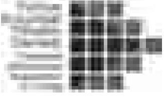

CORPORATE GOVERNANCE ASSOCIATION OF TURKEY PUBLICATIONS

Governance Guide for Family-Owned Companies

"IN THE LIGHT OF CORPORATE GOVERNANCE PRINCIPLES"

CORPORATE GOVERNANCE ASSOCIATION OF TURKEY PUBLICATIONS

GOVERNANCE GUIDE FOR FAMILY-OWNED COMPANIES "IN THE LIGHT OF CORPORATE GOVERNANCE PRINCIPLES"

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PREFACE

Following the 2001 financial crisis, the Turkish government implemented a range of reforms which have enabled the country to become a regional economic power and emerge from the recent global financial crisis relatively unscathed. Instituting a culture of good governance has been a crucial element in this reform process. Since its establishment in 2003, the Corporate Governance Association of Turkey (TKYD), together with its member companies and local and international partners, has played an integral role in raising awareness and advocating better governance practices throughout Turkey and the region. Over the years, TKYD has reached over 1,200 executive directors, board members, owners and managers in 18 cities throughout the country through workshops, seminars and training programs.

TKYD was part of a team of lawyers, NGOs, and prominent academicians who prepared revisions for the modernization of the 1956 Turkish Commercial Code. The revisions to the Commercial Code, which are currently being considered by Parliament, are designed to bring regulations in line with international accounting standards, increase transparency, protect minority rights, and introduce US and European concepts of corporate governance.

TKYD is also a pioneer in developing corporate governance for family companies. This governance guide is the culmination of TKYD's efforts to prepare small and medium sized businesses – particularly family businesses – for compliance with forthcoming governance regulations in the revised Commercial Code. Given that family businesses comprise 95 percent of all registered companies in Turkey, it is crucial that they have a strong understanding of corporate governance in order for reforms in the country to succeed. We hope that this guide

will assist businesses throughout Turkey – regardless of structure or size – in the pursuit of corporate governance best practices and compliance to increase their individual bottom lines as well as the bottom line of the Turkish economy.

I would like to extend a thank you to all of the contributors to the development of this guide, as well as to all of TKYD's valuable members and the Turkish private sector at large. I hope that you find this guide useful.

Tayfun Bayazıt
Chairman of the Board
Corporate Governance Association of Turkey

Professionalism and Corporate Governance

Professionalism must be understood as the development of a “system”, the continuity of which does not depend on the presence of any individual person. Like all other systems, the establishment of a soundly functioning corporate structure requires the determination of the relationships among the various elements within it and between those elements and the system as a whole, as well as the identification and definition of different roles and tasks.

The concept of professionalism infers a focus on the “company” concept. However, in systems like a family company, professionalism must be analyzed in two dimensions: the “professionalism of the company” and the “professionalism of family relations”. Accordingly, it is useful to distinguish between the concepts of professionalism and corporate governance.

Institutionalization indicates:

- creating an organizational structure appropriate for the purposes of the company
- defining roles and responsibilities
- introduction of internal regulations
- transition to professional governance, through delegation of powers and responsibilities

In sum, the aim of professionalism is to ensure a better operational management.

On the other hand, Corporate Governance is more about “control” and “ownership”. For instance, in family companies, which form the subject matter of this publication, priorities are the following:

- creating a family constitution

- identifying relations between the family and the company
- coordination of interests of family members that are and that are not shareholders as well as those who are and who are not directors in the company
- forming a family council
- introducing a conflict management system
- preparing a succession plan
- preparing a shareholders' agreement

These elements ensure that those family members holding the ownership of the family company transfer their assets to the next generations and thereby guarantee the company's sustainability.

In short, corporate governance comprises laws, regulations and voluntary private sector applications which ensure that companies attract capital and human resources, show effective performance, achieve their goals, and fulfill their legal obligations and social expectations.

Corporate Governance Principles

Corporate governance is based on four basic principles: fairness, responsibility, transparency, and accountability.

Fairness

The Fairness principle entails the equal treatment of all stakeholders by the company's management. This principle is intended to protect all shareholders' rights, including those of minority shareholders and foreign shareholders.

Responsibility

The Responsibility principle is related to companies' compliance with laws and regulations that are aimed to protect communal values, while creating value for their shareholders. However, corporate governance principles generally

emphasize that laws establish the minimum standards with respect to responsibility, and that the real attitude of a responsible company would be voluntarily exceeding the standards set forth by laws.

Transparency

Best practice requires the sharing of accurate, clear and comparable information with the public in a timely fashion. After all, investors will be able to efficiently manage their resources only if they are provided with quality information. For this reason, in addition to its past performance, the announcement of the company's future aims as well as any significant risks that the company may encounter in the future, are crucial for good governance. This principle encourages regulations aiming to develop opportunities for feedback, not only reactively with respect to activities already conducted but also proactively with respect to activities being conducted by the company.

Accountability

The framework of corporate governance should ensure the company's strategic guidance, the board of directors' efficient supervision and the board's accountability to the company and its shareholders.

Why is Corporate Governance Important for Family Companies?

As in many economies, Turkish family-owned companies undertake a very large portion of the country's economic activity. Although it is generally claimed that family companies carry out their activities through groups of companies comprising more than one company within their structures and that by cooperating within their group structures they are less affected by economic crises, their activity duration does not last very long as they tend to fail in establishing the necessary professionalism and experience problems in the transfer of the company's ownership from one generation to the next.

Most family companies disappear in the first generation, while the number of companies surviving in third generation is very low. In a study performed in the USA, it was revealed that the rate of family companies ceasing to exist in the first generation is 80%; the rate of those reaching the second generation is 16%; and the rate of companies

reaching the third generation is only 4%.

Considering the large share family companies contribute to the country's economic activities, it becomes evident that the implementation of corporate governance in family companies is a very important process. In family companies, corporate governance is not just a process that can be realized by the head of the family and the founding members of the family company, but it is a collective process. Consequently, there is a process of learning and changing and, accordingly, transition and compliance costs do occur.

Family companies that have gone public and are traded at the stock exchange are able to implement corporate governance practices in a more effective and faster way. Many of the mentioned practices, however, can be said to be implemented in order to ensure compliance with the regulations of relevant regulatory and supervisory authorities. Apart from that, there are some family companies that are willing to meet all requirements of corporate governance and that have made significant progress in this matter.

Family companies may prefer going public primarily as an alternative low-cost financing instrument, but they may also regard it as a phase of transition to professionalism and corporate governance. However, the decision for a public offering will provide the opportunity for the family company to accomplish both objectives at the same time. Family companies going public and starting to be traded at the Istanbul Stock Exchange (IMKB) will enhance professionalism and good corporate governance practices in the companies, accelerate the sustainability of these companies, and ensure low-cost financial resources at the same time. Considering that 15 of the companies listed in the IMKB-30 Index, comprising the greatest companies traded at the IMKB, are family companies, it is clear that being a family company does not constitute a hindrance for being traded at the IMKB, but on the contrary many large family companies prefer this status.

Family Companies and Corporate Governance

As corporate governance principles have a direct impact on the ability of all companies to sustain their activities in a stable manner, these principles have also gained importance for companies not

traded on the stock exchange. Even if family companies show a rapid performance increase during their starting years because of their specific advantages, there is need for developing certain regulations to ensure sustainability of performance when the company grows and relationships become more complex. In other words, entrepreneurs need to “manage growth” in order to continue their success.

For instance, the more a business develops and grows and the more investments are made in various fields, the more financial officers feel the need for working with professional managers. Thus, the roles of the shareholder who takes the risks and the professional manager making decisions in return for wages become apparent. Consequently, a distinction between ownership and management appears. When this distinction arises, the need for applying corporate governance principles becomes more evident. It should be borne in mind that a successful entrepreneur may not possess all the critical resources and personal qualities required for managing growth.

A second important element concerning family companies is the way the family itself grows irrespective of the company’s growth process. Even if the family company, by demonstrating a satisfactory performance meeting the financial expectations of the entrepreneur, shows constant growth, it may not meet the financial expectations of the family as it grows into the second and third generations. Therefore, the financial expectations of the family members with regard to the company must be clarified and accordingly a performance level must be specified.

An expanding family may bring along new groups of shareholders, such as shareholders employed in the company, non-shareholding persons employed in the company, and non-shareholders that are not employed in the company. These groups and/or individuals may have interests differing from the interests of the family. When differing interests of these shareholder groups are not managed well, family conflicts regarding the business can threaten the company’s continuity. Corporate governance aims to establish mechanisms for discussing and

balancing varying expectations of family members, thereby preventing the company from coming to a dead end due to internal disputes.

Another issue that brings corporate governance principles into prominence is capital. When the family's capital falls short, the company becomes compelled to be in communication with a wide variety of persons ranging from corporate investors and financial institutions to individual investors. As a consequence of forming partnerships resulting from such circumstances, the mutual responsibilities of the parties towards each other make corporate governance inevitable. After all, one of the primary purposes of corporate governance is the protection and development of the title holder's rights resulting from the equity partnership.

Corporate governance is also important for the regulation of the relationship between the family and the company, which is the primary condition for sustainability. Corporate governance regulations developed for family-owned companies enable:

- transparency of performance of professional executives
- appropriate compensation schemes on the basis of performance and fair market conditions
- prevention of the family members' blocking the career development channels of others
- family members and professionals being subject to the same performance system
- identification of decision making powers and areas of responsibility, thereby allowing the company to gain talented executives

These applications intend to make proper assessments of persons with regard to their usefulness to the company and to prevent any possibility of losing valuable professional executives. Additionally, the family member shareholders, who are the most important group of stakeholders but do not participate in the company's management, are given the opportunity to question the company's performance and to have a say in important policy-making decisions such as dividend distribution, succession related matters, delegation of powers and authorities, decisions regarding joint expenses and undertaking debt. Moreover, possible harmful conflicts of interest may be prevented by setting rules for transparency and employment of family members.

Relationship between Family and Company

Generally, the most important difficulty in the transfer of family companies to succeeding generations proves to be the lack of well developed long-term planning. Family companies often act without sufficient planning and long-term thinking and, as a result, they fail to survive upon the death or disability of the company's founding family member. In other words, the main reason for these difficulties is their failure to understand the importance of professionalism. When we examine "sound" family companies in this context, we see such features as interdependence, trust, mutual appreciation, open communication, spending social time together, mental health, and the ability to struggle with vital problems. Family companies unwilling or unable to incorporate these elements can be shown as examples of family companies that will not survive. Therefore, such good practice models should be realized by adapting them in accordance with the specific characteristics of each family company.

Recommendations for the Transition Process

As indicated above, a professionalization process during which the family members' business expectations are balanced and the relationship between family and business are formalized is an important initial step for the establishment of a sound corporate governance system.

In family companies undergoing the transition process and including only family representatives of the first and second generation, a tripartite system, consisting of a family council, a family board and an advisory committee is a model recommended for the successful management of the transition process.

Family Council

Family councils are forums intended to increase intra-family communication and are increasingly utilized by family companies throughout the world. If used effectively, family councils may help to overcome problems such as poor communication and

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1 N.Stintet & J.De Frain, "Secrets of Strong Families", 1986, Little Brown Co.

the inability to express one's opinion in the circle of the extended family. Family councils provide a framework for dialogue and therefore facilitate a free and open communication among family members. The family council may determine the prerequisites for family members with regard to employment in the company, it may prevent different perceptions by clearly revealing disagreements, resentments and expectations, it can eliminate family conflicts, and it may be used as a platform for creating a family constitution.

The establishment of a soundly functioning family council is subject to certain conditions. First of all, membership to the council must be open. It is common to see eligibility criteria for membership, such as age. The operational rules of the family council should be determined by the family.

Unlike a board of directors, the fundamental character of the family council is openness and wide participation. It is not a board of directors. Not all members of the family council should be part of the board of directors.

A family council may function slowly during the initial period following its creation. Families that are not used to frank and amiable communication may be shy about discussing sensitive topics at the beginning. In such cases an experienced psychologist may be helpful.

If the family council gathers regularly with a pre-determined agenda, it will strengthen communication among the family members. Establishing working groups within the council may help younger members of the family to prepare themselves for management responsibilities and enable the formation of new groups over time which may perform important tasks on behalf of the family.

Family Board

While the family council is based on an open participation concept, the family board is a decision making mechanism, primarily consisting of shareholder family members and focusing on areas in which concepts of family/business and shareholding/management overlap. Apart from shareholder family members performing various executive

functions in the company, shareholders who are family members without executive functions may also participate in the family board. The family board shapes the future of the company, holding open the effective communication channels with the family council, working towards the establishment of a corporate system independent from specific individuals, and preparing the infrastructure required for the sound transfer of the company to the next generation.

The success of the family board largely depends on establishing a balance between three critical variables: the company's capital needs, the degree of liquidity needed to satisfy the personal financial needs of the family members, and the need of the owners to control the company.

During the transition process the family board may be considered as the organ that functions as the board of directors, moving toward the establishment of a sound corporate governance structure.

Advisory Committee

The advisory committee is a mechanism established in order to support the family council and the family board during the transition process. It consists of experienced professionals trusted by the company's shareholders. The advisory committee can be consulted prior to adopting critical decisions. Members of the committee should have the qualifications to be able to advise the shareholders and openly discuss their ideas with them. The advisory committee will make significant contributions in the transition process by undertaking roles in important processes such as the determination of appropriate family members to take over the company's management, specification of the qualifications required from family members that will be employed in the company, and mentoring of the younger family members.

In companies where two or more generations work together, more than one core family is included, and a certain level of financial size has been reached, a relatively more structural corporate governance system is needed, comprised of a family council and a formal board of directors instead of the tri-partite mechanism mentioned above.

In the network of relationships becoming increasingly complex

with the company's development, the board of directors is the highest authorized body of a company, comprised of persons from both within the family and independent of the family and with no executive position in the company. The board of directors is responsible for observing the interests of both the family as well as other shareholders.

Creation of Formal Policies

During the professionalization process, the creation of formal policies for critical matters in which family and business intersect are required once the above mentioned mechanism have started to function. The family constitution is a basic means by which such policies are stated in written form.

Family Constitution

Developing a structure that will enhance communication between family members and ensure the family's goals improves the trust between family members, but establishing procedures to administer these matters requires time and financial investment. One of the important means of creating and applying family decisions is the family constitution.

The family constitution expresses the values, philosophy, rules and expectations of family members, as employees or employers, in matters that involve them. This constitution is a living document. Its contents must be flexible and revised regularly in order to meet the changing needs of the family.

In principle, this constitution is a compendium of policies arranging the manner in which the family and the business interact with each other. Generally, it includes the family's mission statement as well as the family's philosophy or vision and values.

The family affects the business and the business affects the family. The family-based business plan is different from the plans of other business sectors. Family factors affecting the business include matters such as the number of children, their capacities, and the family's history. In turn, business factors that affect the family are issues such as size, geography, growth, and cash positions. When establishing a family constitution, it is important that the goals and business strategies of the family are aligned.

Certain Constitutional Politics		
	Entry / Employment / Leave	• Who can work in this job? • How do they get promotion?
	Benefits / Bonuses	• How is it determined? • Who determines?
	Partnership Agreement	• Who can owe the shares? • Who can sell, when and to whom?
	Converting into Cash	• At what price shares can be bought? • Who determines the price? • Is there any formula to set up the price?
	Family Council	• Who can take a part into? • What are the roles of council members? • Are benefits provided to council members? How is it determined?
	Dividends	• How is dividend determined? • Who determines the dividend?
	Communication	• How does Family set up the communication with business environment and public environment? • Which issues are confidential? • At which level are the business issues declared to Family members and to shareholders?
	Ethics	• What are the behaviors expected from Family members?
	Charities	• Are there any charity business of the Family coordinated? • If exists, what are the priorities of the Family? • How should the charity initiatives of the Family be financed?

Source: Deloitte Times September – October 2009

Succession Planning

Another critical issue for sustainable performance in family-owned companies is succession-planning. Good governance allows family companies to plan and manage this process effectively and to prevent possible crisis proactively.

Two difficulties may arise as children of the founder/founders prepare to take part in the management of a growing company: Either the founder is unwilling to step down and transfer authority to the next generation or the children are unwilling to take over the business.

The first and more frequent instance occurs when the founder doesn't trust the next generation's ability or is simply unwilling to give up authority. If, indeed, the founder has not invested sufficient trust and training to the heirs-apparent when they were young, and/or if they have developed other interests outside the family business, the next generation will naturally doubt their ability to take over administrative leadership.

The plans for the future transfer of authority should be created and implemented as soon as possible in order to protect the assets of the family and to provide continuity of the company from generation to generation. In cases where this planning fails to occur, conflicts of interest are unavoidable, and more importantly, such conflicts are bound to have a negative effect on the management of the company. Any successor who does not want to participate in the family business becomes a risk factor that may eventuate in the sale of the shares to persons outside the family or the disruption of the company in other ways.

A succession plan for the transfer of the management between generations is the key for the continuity of the company. Any delay in the implementation of succession planning may cause disputes within the family and result in inefficient decision making.

Succession plans include:

• training and development of the new generation

• applying a talent test to family members

• investigating the children's potential and interests fairly and adequately

• identifying the right organizational roles based on the capabilities of individual family members

A succession plan involves particular training and development measures for each family member from a young age within the framework of a fair and equal system. This system should be considered as a training and development system in which:

• the children are all well educated

• they become accustomed to working in the family business and/or other companies during their education lives

• they grow up with the family's basic values

• negative behavior is identified and corrective measures are taken

• the children are trained in the skills required in those business fields the family company wants to invest in

• their development is continuously reviewed and reported, and their feelings and thoughts are taken into consideration.

When such a system is created and implemented it is crucial not to favor any individuals or groups in the family. No distinction should be made between girls and boys, the personal characteristics and performance of all children should be taken into consideration, and all measurements in the training and development system should be equal and fair without any room for doubt.

A written succession plan has to be prepared and approved by all family members. Otherwise problems in the implementation will be unavoidable. The succession plan should be reviewed by the Family Council regularly and should be adapted to current domestic and international developments.

Expectations of the Stakeholders

Corporate governance secures a sustainable company performance by providing an opportunity for dealing with the expectations of different stakeholders. Good governance is of critical importance for non-public companies in order to achieve long-term success. Within this scope, it is possible to eliminate typical obstacles which hinder the growth of family companies. By virtue of corporate governance the success of one generation can be passed on to future generations. Corporate governance prevents ambiguity in the process of determining the roles that may be carried out by family members of the younger generation. It helps to solve problems occurring during the transfer phases between generations, for example different needs of active and passive family members. In short, corporate governance ensures the contribution of the growing family to the company management and enables profitable growth of the company.

Some of the important contributions ensured by Corporate Governance to family companies are:

Corporate Governance ensures that the company structure is more resistant to crisis

Applying corporate governance principles in a family enterprise ensures

the presence of an effective risk management system, an effectively operated internal control system, an internal audit department, a board of directors taking fair decisions and performing effective surveillance, and a productively functioning organization.

Corporate Governance increases the company's performance

Acting according to the corporate governance principle of accountability enables a company to create systems to monitor management performance objectively. This monitoring system ensures that the board of directors serves the goals of the company and guarantees improved performance.

Corporate governance principles suggest that the performance of the board of directors be assessed both collectively and individually. Such performance assessment provides clarification of the individual and collective duties of the members as well as feedback showing how successfully such duties were fulfilled. This ensures that the board of directors makes maximum contribution to the company. In the same manner, the performance of the top management should be systematically assessed by the board of directors based on the level of achievement of the goals of the company. This system requires the management to set up realistic, specific and measurable targets. Thus, performance is continuously monitored and controlled.

Corporate Governance enables the efficient use of financial resources

Corporate governance principles increase the reputation of the company in the eye of all stakeholders, particularly banks and financial resources. The company accesses financial resources in an easier and cost efficiently manner, and thus enhances its competition opportunities.

Corporate Governance increases competitive power

The most important factor enhancing a company's ability to compete is good governance. A company that is governed well enhances its competitive power in all respects: its decisions are made effectively and efficiently, gaining a competitive edge.

Corporate Governance plays a key role in merger and acquisitions

Today's increasingly competitive markets have brought corporate governance principles into prominence because of the escalating tendency toward consolidations. The gradual increase in mergers and acquisitions in

business life has, of necessity, caused a change in the way business is done. Any company with formalized business processes at the level of the board of directors and the top management has a substantial advantage following amalgamation. Corporate governance principles help to formalize issues which have not been defined clearly before the merger due to trust arising from long term relationships. Formalizing mutual responsibilities facilitates accountability among the partners and establishes healthy business relations. This can be achieved, for example, by the following measures: election of the members of the board of directors, definition of their duties, preparation of annual working plans, development of performance assessment methods, and ensuring that meetings of the board of directors are based on an agenda.

Corporate Governance enhances the company's reputation

Applying corporate governance principles increases the reputation of a company in the eyes of the public, financial institutions, suppliers and customers. Increased reputation of the company is one of the most important factors to increase the trust of the stakeholders.

Corporate Governance facilitates the formation of domestic and foreign partnerships

Corporate governance plays an important role in increasing the value of the company in positions gained by a family-owned company and its products in new markets. International collaborations and partnerships become viable.

Corporate Governance increases the company's value

Well governed companies keep their competitive powers and make them efficient in their respective sectors. Consequently, the value of such companies increases over time. Sales of such companies to foreign investors or other local investors, partially or as a whole, substantially increase.

Corporate Governance ensures sustainability

Corporate governance systems maximize professionalization in the company, ensuring that the relationships between the professional company and the family are in organized. In this way, family and company cannot affect each other negatively, but rather support each other. Corporate governance minimizes possible departures from the company, disruptions and conflicts, so that the company continues from generation to generation.

Issues Specific to Family-Owned Companies

Both in Turkey and around the world most companies are family-owned. This brings a number of managerial advantages, such as:

• decision making and implementation mechanisms operate efficiently, since there is no separation between ownership and control mechanisms

• income levels of entrepreneur family members are high

• loyalty of family members to the business tends to increase consistency

However, there are also a number of factors that pose threats to family enterprises, for example changing economical and legal conditions and difficulties experienced in the management of family relationships. In case these factors are not well analyzed and planned for, problems may occur in the continuance of the company to the next generation.

The Needs of Family-Owned Companies

The guide examines the participation of the family members in the company and the economic phase experienced by the company from two different approaches and offers solutions.

NEEDS OF THE FAMILY MEMBERS DEPENDING ON THEIR PARTICIPATION IN THE COMPANY	
Founders	■ Leadership and power transfer planning ■ Ownership transfer and succession planning
Participation of the children	■ Providing team working and conformity ■ Determination of management policies ■ Succession planning
Participation of the cousins	■ Protection of shareholding rights ■ Dividend policies ■ Policies for settlement of conflicts ■ Establishing the family vision statement ■ Disciplining the ties of the family with the business

Founders

This is the first phase of the existence of a company. The company together with all its functions is under the control of the founder. Owners who are also founders and controlling executives sometimes receives consultancy from outside, but they make all decisions with respect to the management of the company. In this phase, the founder's efforts to succeed, and his/her loyalty to the business positively affect the growth. Simplicity in the management and fast decision making mechanisms facilitate the management of the company. This phase, the simplest sort of managerial power, is observed in the phase where ownership and control belong to the same person. Succession and planning for the transfer of power are the most important issues in this phase; the planning for providing the next generation with education and experience should be made in this phase.

Participation of the children

This is the phase in which ownership and management is transferred from the founders to the second generation. In this phase, where one or more family members participate in the company, corporate governance gets more complicated. Important issues are: ensuring uniformity of treatment among the children, implementation of the authorization policy, preparation and implementation of managerial procedures, forming sound communication both between the family members and with professional executives in the company, and succession planning for the key management positions.

Participation of cousins

In this phase, management gets more complicated as more family members participate, directly or indirectly, in the business. This includes individuals from different branches of the family, representing different generations with varying points of view and opinions on how to manage the company, the risks that should be taken, and general management strategies. In addition, animosities and discordances that may come from previous generations may redound to the cousins and thence to the business. As a result, this is a phase that requires both management of the company and management of the family. The most important issues in companies experiencing this phase include establishing a sound policy for

the employment and authorization of the family members, the protection of the family members who have shares in the company, the dividend policy, a mechanism for the settlement of the disputes, and setting up the family vision statement.

Each phase contains problems that require different sorts of interventions. Nevertheless, most problems can be overcome by the intensive efforts of the founders, and their loyalty to the company as it starts to grow. The following factors are important for sustainable growth and for securing the long-term survival of the company: formation of managerial structures and mechanisms, granting authorizations, setting up the company's targets and visions and ensuring that the family members are loyal to them.

ISSUES SPECIFIC TO FAMILY-OWNED COMPANIES

TRIGGER FACTORS	PROBLEMS	SOLUTIONS
	Discontinuance of the company to next generations	■ make a succession plan, ■ assess properly the tendencies and skills of the family members, ■ encourage the family members to create company strategy
Fast changes experienced in the competitive environment and the technology	Conflicts between the benefits of the family and the company	■ prepare a family constitution with the participation of all family members, ■ continuously observe the family members and company benefits, manage this balance in an objective and independent assessment
Local, regional and international socio-cultural and economic changes	Employment of executives outside the family and keeping them employed	■ define properly the relationship between the company and the family, make sure that the professional management staff understand well these definitions, ■ act in accordance with the company policies when making decisions and assessments
Creation of alternative markets, and alternative products and manufacturers entering the market	Lack of vision, weakness of the entrepreneur in flexibility, competition within the company	■ make sure that the board of directors contain members who are independent and have different point of views, ■ form a system and discipline to obtain the maximum benefit, and conform thereto
	Restrictive equity capitals, and losing the control because of the needs for capital	■ consider the medium and long term company benefits when making assessments , ■ focus on the company benefits as a whole when analyzing the benefits

NEEDS OF THE COMPANY DEPENDING ON THE ECONOMIC PHASE EXPERIENCED

CATEGORY 1	CATEGORY 2	CATEGORY 3
Single owner companies supported by one or several of the family members	Companies in the growth phase having other employees besides the family members	Companies with many shareholders from inside and outside the family
A reliable pre-accountancy and a practical internal control	An official accounting system	Internal control system
Simple performance criteria	Detailed 3- and 5-year business plans and annual evaluation	Clear goals and suitable planning
Analysis of business risks and appropriate policies	Multi-purpose performance criteria	Performance indicators and measurement system
A simple business plan or strategic plan	Risk analysis and risk management	Risk management system
Consultancy services (Legal - Financial)	Compensation and general human resources policy	Company policies, a system relating to their application and reporting
A simple succession planning	Succession planning supported by a family constitution	Written Articles of Association
	A system ensuring the transparent sharing of the company's financial structure	A competent board of directors
	Consultancy and counseling services	A system regulating the transfer of the authorities of the board of directors
	Simple policies relating to decision making mechanisms	Mechanism for measuring the performance of the board of directors

D BY IT

CATEGORY 4	CATEGORY 5
Multi-owner companies	Publicly traded companies
All system functions and applications required by the 3rd category	All system functions and applications required by the 4th category
Sophisticated systems for ensuring sustainable growth	Capital Markets Law and provisions of all legislations such markets are subject to
True loyalty to the accountability principle	
Provision of records relating the corporate governance past prior to initial public offering	
Transfer of all company management authorities and liabilities to the board of directors	
Creation of a system enabling the sale and purchase of shares	
Establishment of a board of directors and creation of specific policies and guidelines relating to its operation	
Formation of committees	
Control and administration of the execution	

Policy Recommendations The creation of a family constitution is among the basic recommendations made to family companies. As families enter this process, they need to be very clear as to whether the "company" or the "family" has precedence and act accordingly. The following table contains samples about the formation of managing policies depending on the priority determined by the family members:

PROBLEM	FAMILY FIRST COMPANIES	BUSINESS FIRST COMPANIES
Human resources policies	An "open door" policy for hiring family members often becomes a safety net for those who cannot succeed outside the business.	Open only to those family members who are appropriate for the duty and the business. The criteria required by the duty such as training, skills and experience are clearly defined for all employees inside and outside the family.
Remuneration and reward policies	A family-fairness rule may be applied: everyone is paid the same, regardless of their experience or contribution to the business.	Compensation is based on market and industry measures, not family need. Accountabilities and reporting relationships are clearly understood. High performers are highly paid. Family members may be terminated for non-performance.
Leadership	Leadership is based on seniority, rather than demonstrated competencies or success.	Leadership is earned. The family mantra is to have "the best and the brightest" running the business, family or non-family. Non-family senior execs may be recruited from within the industry, although some companies successfully grow their own top teams.

PROBLEM	FAMILY FIRST COMPANIES	BUSINESS FIRST COMPANIES
Using business resources	Vacation homes or cars are funded with company money, diverting resources from strategic use.	Budgeting and planning is important; earnings are used for growth initiatives. Distributions are based on family ownership but generally limited to amounts needed for taxes plus a small dividend. Family dividends are sufficient for the family but not excessive.
Training	Family first companies usually have no formal training programs so family members are expected to intuitively learn business practices.	A training plan is developed. All management staff is trained for their current and future positions in all programs prepared within this planning.

3 Mike Cohn, “Does Your Company Put Family or Business First?”, The Business Journal of Phoenix, January 2005.

Important Mechanisms in Corporate Governance

In family companies the adoption of corporate governance can be realized in two phases:

- Adoption of corporate governance principles within the family
- Putting corporate governance principles into practice within the company

Topics relating to the family have been explained in the previous sections of this guide. In this section, mechanisms for applying corporate governance principles in family companies will be addressed.

In today's world the impacts of globalization have influenced the business life to a considerable extent. Rapidly changing market and competition conditions as well as global crises have deeply affected Turkish family companies, which had been experiencing many structural problems anyway. Those companies having experienced management difficulties due to the inability to follow-up financial position and performance in a proper and timely manner during the crisis are now becoming aware of the importance of certain mechanisms such as risk management, control functions, internal and external audit.

There are several mechanisms which are of vital importance for strengthening the corporate governance understanding adopted in the family and the proper application of such an understanding to the management of family companies. Such mechanisms which ensure sustainable growth and profitability of the companies include:

- Risk Management and Internal Control Systems
- Internal Audit

- Financial Function
- Financial Reporting and Independent External Audit

RISK MANAGEMENT AND INTERNAL CONTROL SYSTEM

Risk management and internal control systems constitute the most important component of the control environment in companies and therefore form the foundation of the corporate governance applications of a company. Risk management helps the company to reach its goals by constantly assessing potential internal and external risk factors and ensuring that relevant measures are taken for the management of the respective risks. The internal control system has an intricate relationship with risk management. Internal control systems reduce the effects of risks by focusing on processes; system and information flow, thus helping to achieve the goals determined by the company management.

Both mechanisms play a key role in the utilization, monitoring, measuring and protection of company resources and are also of a vital importance for the detection and prevention of fraud.

Both mechanisms are summarized below.

RISK MANAGEMENT

Risks are threats and hazards confronting a company on its way towards reaching the goals it has specified. However, by virtue of a good risk management, it may be possible to identify and assess not only risks but also opportunities.

Company shareholders and members of the board of directors should ensure that effective risk assessment and sound management systems exist in the company. This process requires the establishment of a follow-up and reporting system which detects any risk the company may be exposed to.

Effective risk management should comprise all the risks a company may be exposed to: financial, operational, strategic, compliance and fraud. Risk management assists the board of directors in fulfilling their monitoring responsibilities with regard to the company’s management. Moreover, it assures shareholders and other stakeholders that the company is managed in compliance with the relevant laws, regulations and corporate governance principles.

In one sense, risk management systems help the board of directors and the management to establish a culture of routinely identifying, assessing and managing risks. As a consequence of such practices, the impact of risks can be minimized by taking preventive action.

In this context members of the board of directors and executives should ask themselves the following questions:

- What are the risks that affect the achievement of the entity's objectives?
- What are the significance and possible impact of those risks?
- How likely are the risks to occur?
- What measures have been taken in order to reduce the probable impacts of risks facing the company?
- Are the measures taken effective with regard to reducing the impacts of the risk?
- Should the company make changes to its established objectives?

Risks management systems need to be very well structured, but at the same time they should be kept as simple and flexible as possible. Systems which fulfill both criteria can be used most efficiently by the management.

A risk management function is established depending on the size and requirements of the company. The tasks of this department, which will be responsible to the board of directors, is to monitor the risks the company may encounter and to develop necessary policies for the execution of risk management processes. It is recommended to recruit experts having work experience in the fields of accounting, finance, audit, law, management etc.

An effective risk management system will support the improvement of an internal control system, and as such it also constitutes an important basis for the activities of the internal audit function. The internal audit department should assess the effectiveness of the risk management system when planning its activities.

Internal Control System

The internal control system ensures efficiency and productivity of operations, reliability of the financial reporting system, and conformity to the legal regulations. A board of directors and the executives and employees of a business manage their company through this systematic

business processes.

The internal control system has three main purposes and five components.

The purposes of internal control can be summarized as follows:

- Increase of the efficiency and productivity of operations with the assistance of standard processes by utilizing the company's resources at optimum level
- Formation of a reliable financial reporting process
- Ensuring compliance with applicable laws and regulations

The components or internal control are described below:Control environment includes the attitudes, awareness, and actions of shareholders, board of directors and management concerning the company's internal control and its importance in the company.

Risk assessment is a process for identifying and responding to business risks and the results thereof.

Control activities are the policies and procedures that help ensure that management directives are carried out, for example, that necessary actions are taken to address risks that threaten the achievement of the company's objectives

Information systems include all processes relating to financial reporting and communication thereof. They comprise procedures and records established to initiate, record, process, and report company transactions and to maintain accountability for the related assets, liabilities, and equity.

Monitoring of controls is a process to assess the quality of internal control performance over time. It involves assessing the design and operation of controls on a regular basis and taking necessary corrective actions.

In today's business world, an effective internal control system, designed to support the company's sustainable growth strategies, is considered as one of the most important factors to increase the company's value.

What Happens If an Effective Internal Control System is Not Designed and Implemented?

The negative consequences of the failure to effectively design and implement the internal control system are discussed in four main sections.

Weak Controls:

Attitudes, awareness, and actions of shareholders, board of directors and management are not communicated clearly and strongly throughout the organization. Integrity and ethical values and behavior, which are essential elements of a control environment, are neither communicated nor properly reinforced in practice.

Implemented controls are not formally written down and official. Errors and frauds are detected only after their occurrence and procedures that should be performed to investigate non-routine transactions are not conducted by those charged with governance and management properly and timely.

Many errors and fraudulent transactions cannot be prevented due to the fact that controls are not carried out adequately and properly. The following situations are encountered in such companies:

- Misuse of cash and cash equivalents (unnecessary expenses, advances taken etc.)
- Errors and frauds resulting from inadequate and improper account reconciliation procedures
- purchase of products and services at a higher costs mostly due to an insufficient number of offers, inadequate bargaining, and frauds including third parties
- purchases of unnecessarily excessive stocks and fixed assets
- theft and embezzlement
- record of income and/or expense items which do not conform to legislation
- conduct of transactions which are not approved properly

Non-Compliance with Laws and Regulations

If an appropriate system of internal control is not established and operated and management directives including policies and procedures are not appropriately carried out by company owners, board of directors,

managers and employees, the risk of noncompliance with laws and regulations may increase.

Inadequate Security

Inadequate security on financial and physical assets such as cash, bank deposits, inventories, and fixed-assets increases the risk of errors and misappropriation on those assets. Information technology assets, both hardware and software and intellectual property should also be considered in this context.

Inappropriate Information Flow

Documentation flow and corporate memory is weak. In a situation where staff turnover is high, the issue could be more critical. Accountability is not well maintained.

The information flow to the company's owners, the board of directors and the top executives is not healthy due to insufficient management reporting. Therefore, decisions related to management are made without properly assessing financial information. In many instances costing, pricing and profitability cannot be conducted properly before entering into a commercial transaction.

Why Internal Controls are Important for Family Companies?

There is no doubt that improper functioning internal controls are one of the most important reasons behind scandals, frauds and business failures having occurred in Turkey and the rest of the world in recent. In today's business world, the existence of an internal control system functioning properly has become critical for sustainability and growth regardless of the status of the company, such as public, private, and family owned companies.

Below, the question "why is internal control important for family companies" is briefly answered by focusing on "the current status of internal controls in Turkish family companies" and on the benefits that an appropriate and properly functioning internal control system offer.

Current Status of Internal Controls in Family Companies and Risks

Studies and assessments have shown that there are significant weaknesses in relation with the existing internal controls in family-owned companies and that such weaknesses cause serious risks to the companies. Internal control weaknesses that are frequently encountered by Turkish family companies are summarized as follows:

- Controls are not known and adhered to as a result of the fact that they are not defined formally. As a consequence controls may not be functioning as intended.
- Many controls and processes the company's owners or management believe to function in an appropriate manner actually either work only partially or do not function at all or even do not exist.
- There is a lack of segregation of duties in most non-public or family companies. However, in some companies, basic segregation of duties elements are implemented for the sake of protecting the company's assets. This matter is an important factor increasing the risk of fraud in companies.
- While properly designed and implemented controls are expected to prevent errors and frauds from occurring, in Turkish family companies, controls are often detective rather than preventive and are designed to uncover problems only after they occurred.
- Controls related to financial reporting are usually implemented manually, lacking formality and discipline.
- Employees mostly cannot understand or do not question the interaction of work they are responsible for with other processes, particularly with the finance function.
- A significant portion of control errors results from poor communication among operational, finance/accounting, and administrative departments.
- Controls are substantially dependant on the relevant person and the employees prepare insufficient documentation related to the procedures they perform. Corporate memory is not established and serious problems occur when insufficient documentation is combined with a high stuff turnover.
- Although the use of spreadsheets in reporting and analyses increases rapidly, controls concerning the accuracy of such spreadsheets remain insufficient.
- Anomalous and non-ethical procedures and behaviors unwillingly made by family members establish a "role model" on the employees and

destructively effect the efficient implementation of internal controls.

• Family members may execute "non-routine" important transactions in the fast growing operations. These transactions are usually not reviewed from the perspective of financial reporting compliance with laws and regulations and, as a result, the company faces very serious risks after such transactions occurred.

• Communication related to the policies and procedures among departments is poor and effective.

• Many errors and frauds cannot be prevented due to ineffective implementation of controls.

• Management reports comprising elements such as financial position and performance, cash flows, financial analyses and key performance indicators required for running the business are generally insufficient or do not exist at all.

• As a consequence of a poor control environment accountability and transparency culture cannot be established among employees family business owners.

• Poor accounts reconciliation within the company's departments and with external parties leads to an increased risk of errors and frauds.

• There are important security deficiencies in respect of assets, processes and IT.

Although controls are one of the most important elements of professionalization and are crucial for good governance, in family businesses systems are based on the principle of "trust" instead of "control".

Benefits of Effective Internal Controls

Proper design and implementation of an effective internal control system are of vital importance for the sustainability and growth of the company. This point is far beyond the benefit of such an internal control system on just minimizing errors and frauds.

The benefits of well designed and implemented internal control systems may be summarized under the headlines of "reliability", "conformity to the legislation", "financial reporting", and "operational productivity" as can be seen in the following chart:

INTERNAL AUDIT

WHAT IS AN INTERNAL AUDIT AND WHY IS IT IMPORTANT?

Who is affected by effective controls and for which purpose are they implemented?	What are the benefits of effective controls?
I. Increase of the company's reliability	
Shareholders' trust on the system improve	■ Establishment of a structure based on controls and risks ■ Assurance that errors and frauds are minimized ■ Increase of investments
Increased trust of the stakeholders (such as suppliers, customers and banks) to the company	■ Assurance arising from transparency ■ Increased loyalty of stakeholders ■ Improved trust before the regulatory authority
Attract potential investor	■ Higher premium for acquisition ■ Faster decisions by foreign partners
II. Compliance with laws and regulations	
Minimization of risks of interruption/discontinuance of business activities and of risks of possible legal actions (such as legal suits brought by customers, suppliers and employees etc.)	■ Sustainable growth ■ Prevention of losses that may arise from interruption or discontinuance of business activities ■ Decrease of legal expenses
Compliance with the Draft Turkish Commercial Code and Basel II Responsibilities of the Board of Directors Risk identification and management Internal and external (independent) audit Financial planning	■ Helps the board of directors to fulfill its obligations ■ Compliance with laws and regulations ■ Low risk of legal actions and protection of reputation ■ High ratings due to increased creditability and low interest loans as a consequence
Who is affected by effective controls and for which purpose are they implemented?	■ What are the benefits of effective controls?
Catalyst in opportunities for public offers/bond issuance in domestic and international capital markets	■ Acceleration of public offering processes as a result of an efficient planning and fast information flow ■ Performance and completion of independent external audit in a relatively short period of time ■ Obtaining high ratings regarding compliance with Corporate Governance Principles and high share values as a consequence

Who is affected by effective controls and for which purpose are they implemented?	What are the benefits of effective controls?
III. Accurate and timely financial reporting	
High quality financial information required for the management of the company Cost controlling as a result of the cease of hyperinflation and resulting decreasing profitability Globalization and increasing competition	■ Establishment of an effective management reporting (financial analysis, financial planning and budget system) ■ Opportunity for fast and effective decision making ■ Profitability resulting from increasing competitiveness
Financial statements showing a true and fair view where errors and frauds are minimized	■ Compliance with laws and regulations ■ Protection of reputation ■ Prevention of material losses
Relationship with external auditors Changes in accounting and auditing standards	■ Obtaining value for money on control, risk based and value added external audit ■ Company's capability to prepare financial statements in accordance with changing accounting standards
IV. Operational Performance	
Clarification in respect of roles and responsibility between the management and employees	■ Increasing productivity and motivation as a result of effective job allocation ■ Decrease of dependency on key employees
Operations	■ Effective control on costs as a result of effective and productive business processes ■ Optimum utilization of resources (such as human resources and systems etc.) ■ Minimization of operational errors ■ Effective and continuing operational risk assessment

Consequently, an effective internal control system adds value to the company from many aspects and supports a sustainable growth strategy of the company.

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.

In accordance with the generally accepted approach applied in the decision making mechanisms of company boards of directors and management, internal audit is based on financial and non-financial information the quality, completeness, and accuracy of which is controlled and evaluated. At this point the necessity for establishing an internal audit mechanism becomes obvious.

The internal audit may cover many areas in accordance with the demand and needs of the shareholders. Productivity of operations, reliability of financial reporting, prevention and investigation of fraud, assets protection, and compliance with laws and regulations are the most important subjects included in the areas of internal audit activities.

It could be critically important to benefit from internal audit activities during the professionalization process and implementation of corporate governance in family companies in order to find a balance among shareholder family members, the board of directors and the management as well as protecting the rights and interests of shareholders and stakeholders.

How Does the Requirement for Internal Audit Develop in Family Companies?

When looking at world-wide practices, the internal audit mechanism is one of the basic concepts of business economics which emerges from the basic needs of the company's shareholders. The most important need in this respect is to protect company assets. This demonstrates the internal audit's function of providing assurance and protecting value. Issues frequently faced during the establishment of an internal audit mechanism in Turkish family companies can briefly be explained by virtue of following maturity levels:

There are three basic approaches preferred in initializing the internal audit activity within companies. The approaches are:

(1) Initialization of the internal audit activity by establishing an

internal audit department or employing an internal auditor within the company (insourcing)

(2) Obtaining internal audit services from a consulting firm outside the company (outsourcing)

(3) Simultaneously insourcing and outsourcing (co-equal sourcing)

Internal audit activity is not necessarily an activity performed with

MATURITY LEVELS WITH REGARD TO A COMPANY'S NEED FOR INTERNAL AUDIT

LEVEL 1

- Company is small or medium sized
- Company shareholders or family members carry out informal controls themselves at the transaction level in order to protect company assets.
- These controls mainly focus on cash, money in banks and inventories, which are the most important financial information for the company management.
- Other financial information, risks and controls related to operational processes, and compliance with laws and regulations are not the company's priority.

LEVEL 2

- Company is rapidly growing and family members still want to keep control at the transaction level.
- In this level, trustworthy persons are often utilized to perform controls
- Dependency on individuals is beginning to increase in the organization.
- Controls performed are not formally written and they are not consistently performed in a holistic perspective.

LEVEL 3

- Company shareholders and managers start to face errors and frauds frequently in the organization as it grows and complexity increases.
- Although there are many errors occurring at the transactions levels, a sense of responsibility is not developed in employees because a control environment is not established and the principle of accountability is not adopted.
- Concern of company shareholders and management to focus on the protection of assets (including many factors of financial reporting, operational and laws and regulations risks), and the need for a robust control system and audit is increasing.

LEVEL 4

- Shareholders decide to establish an independent and objective internal audit mechanism mainly focusing on protection of assets and capital.
- Internal audit activities start to be planned and carried out within a program focusing on the protection of assets (including many factors of financial reporting, operational and laws and regulations risks).
- Company starts to obtain sufficient assurance from the internal audit mechanism in line with its objectives

LEVEL 5

- The expectations of the internal audit mechanism increase and become varied at this maturity level.
- Internal audit starts to focus on performing audit activities regarding internal controls, financial reporting, compliance with laws and regulations and operational processes throughout the company from the perspective of "value protecting".
- The main focus of the internal audit shifts from "value protecting" to "value adding". In this advanced maturity level, the internal audit provides consulting services that add value such as improvement of business processes, operational productivity and enterprise risk management.

internal sources of the enterprise, but it may also be outsourced. The preference of one of these approaches is dependent on the size of the company, the attitude and understanding of the management, and the provisions stipulated by the regulations applicable to the industry.

The fact that the internal audit activity can be performed by outsourcing, insourcing, or both simultaneously, allows to acquire the know-how, qualification and equipment required for an effective internal audit activity in an economical and productive manner. Furthermore, internal audit ensures independent, objective assurance and consultancy at the same time.

Depending on the resources available, the factors that affect the success of the implementation are stated below:

If the internal audit activity is conducted with the internal sources, the senior management must ensure that an independent and objective internal audit activity will be maintained in accordance with the international standards and that they will support fully such activities. The qualifications of individuals to be appointed internally and externally

to undertake the audit must be suitable for the task, selected from among individuals possessing professional certificates or being professional certificate candidates. The internal audit activity must be positioned within the structure of the company organization so that its independence and objectivity may be ensured. Therefore, it must be independent of the executive positions.

If the initialization and establishment of the internal audit activity is outsourced, the qualifications, equipment, reputation, experience, and references must be appropriate and it must be ensured that no financial, corporate or personal relationship exists which may affect independence and objectiveness.

Personnel working in the internal audit unit must possess a sound education and previous work experience. Features such as professional competence, honesty, objectiveness, monitoring skills, problem solving and analytical thinking, communication skills, active hearing, interviewing techniques, professional skepticism and reporting are among substantive characteristics to be provided by internal auditor. The internal audit activity must be independent and internal auditors must act objectively when performing their duties.

In order to ensure that the personnel appointed for internal audit activities can fulfill internal audit responsibilities within the company, such personnel must be subordinated to a management level that could provide appropriate supervision. Only in this manner can the scope of internal audit activities be executed free from any inappropriate intervention. This management level may be determined by virtue of the company's management philosophy and corporate governance practices.

It is accepted practice that the internal audit department reports to the audit committee or to the board of directors. Sometimes such reporting is made to the executive board or to the company's general manager, but in the light of the aforementioned explanations this is not the best way.

EXECUTION OF INTERNAL AUDIT ACTIVITIES IN FAMILY COMPANIES

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4 IIA, Uluslararası İç Denetim Standartları Mesleki Uygulama Çerçevesi, TİDE Yayınları, No: 3, sayfa 3. 2004

5 Uzun, A.K., İĐletmelerde İç Denetim Faaliyetinin BaĐlatılmasında BaĐarı Faktörleri, www.denetimnet.net, Nisan 2007

Generally, the role undertaken by the internal audit unit in a family company can be summarized as follows:

- It assesses the efficiency and sufficiency of processes, policies and procedures relating to internal control, risk management and corporate governance.
- It regularly reports significant findings relating to such processes, policies and procedures and, if necessary, provides recommendations for areas requiring improvement.
- It offers suggestions to the management for resolutions to internal control weaknesses, follows-up suggestions whose implementation has been agreed upon and reports recommendations that have not been implemented in a timely manner together with the reasons of not implementing.
- It provides information about the execution of annual internal audit plans and the sufficiency in internal audit resources.
- It coordinates the internal audit activities throughout the company with the respective parties (accounting finance staff, risk management staff) and the independent external auditor.

The execution phases of the internal audit are summarized below:

I. Phase - Assessing Risks and Preparing an Audit Plan at the Corporate Level

In this phase corporate goals and the risks likely to be encountered when reaching these goals are identified. Considering this risk assessment and the management's risk appetite, the areas that will be focused on in the internal audit are determined and an audit plan is started to be prepared.

II. Phase - Planning the Audit Engagement and Identifying its Scope

Control objectives are identified within the framework of activities, processes, and systems to be audited and a "Risk & Control" matrix is prepared by comparing the identifies risks with such control objectives. Within the scope of this work, fraud risks are also considered. Subsequent to this phase, a detailed "audit plan" and "audit programs" are prepared.

III. Phase - Conducting the Audit

The auditor kicks off his engagement in order to understand the

processes and systems throughout the company. At this stage, process maps are prepared and risks and controls are identified on such process maps. As a result of the assessment regarding the functioning of the available control mechanism, any updates required for the audit plans and programs are made. After this phase, controls tests and substantive tests are performed.

IV. Phase – Reporting

All potential findings are identified and prioritized with regard to their importance and impact and suggestions are prepared and reported in order to resolve such findings.

Relationship between the Internal Audit and the Internal Control

The internal control and its importance were mentioned in the sections above. The internal control is a mechanism within the processes and flows of work, being affected by individuals and used for achieving the goals of the company. Well functioning internal control improves assurance and is therefore, naturally, the responsibility of the management. Internal audit, however, is an assessment function evaluating the design and efficiency of internal controls of companies' and thus must be independent of the management. Therefore, internal control and internal audit are two concepts differing from, but also completing each other.

Benefits from the Internal Audit Mechanism

The benefits of the efficient establishment of internal audit departments in companies are summarized as follows:

- Provision of assurance to the board of directors and management concerning the protection of assets and capital
- Determination of operational improvement areas and provision of suggestions for resolutions of issues
- Measurement of the company's performance and determination of factors that prevent attainment of objectives
- Presentation of opinions with respect to the efficiency of the controls

- Determination of risks and assistance in the management of risks
- Assessment of the company's activities as to compliance with laws and regulations and strengthening of such compliance
- Development of a culture of accountability and transparency among all employees, including company shareholders, board of directors and management.

FINANCIAL FUNCTION

One of the most important mechanisms in implementing corporate governance principles in Turkish family companies is the finance function.

In the light of current practices the finance function (accounting and finance) primarily focuses on keeping accounting records and activities relating to compliance with tax laws and regulations. However, in an environment where business life becomes difficult, the basic function that is expected from the finance function is to ensure that financial information to support the company's strategic decision making mechanism is provided in a timely and proper way and to provide support and assurance to the board of directors and management. With such value adding activities the finance function will support the company's "good governance" and accordingly its sustainable growth. Thus, at this point the close relationship between finance function and corporate governance becomes evident.

The finance function department plays a crucial role in risk management as it structures and monitors the internal control system and generates reports comprising reliable information required by all stakeholders including also family members and performance management. This shows the essential importance of the financial function department within the implementation of corporate governance.

Such topics as management reporting, financial reporting, budget, financial planning, profitability analyses, tax management and planning, controlling and reducing costs, compliance with laws and regulation and protection of assets, being in the focus of the finance function, are very important elements of particular concern to all stakeholders of the company and must be implemented in a very

proper manner.

It is the responsibility of the board of directors to structure such a finance function with the aforementioned vision. In this sense, an efficient finance function, in addition to technical features, requires the employment of personnel with managerial skills and information technology infrastructure. However, the benefits of such an investment far outweigh its cost.

Financial Reporting and Independent External Audit

Transparency, the most important element of the corporate governance principles, refers to rules set out for the purpose of giving trust in particular to the financial markets. How does this trust evolve? This process contains two phases. First of all, the financial information of companies should speak the same language as generally accepted systems. Then, they must be subject to independent audit. In today's business world, this common accounting language is the International Financial Reporting Standards (IFRS). Most of the developed countries have completed or are in transition to the IFRS.

In order for a family company to be listed in the stock exchange in Turkey (or in any developed market), to attract private equity or venture capital, and to participate in competitive markets, fully transparent financial statements should be prepared in according with the IFRS and be audited in accordance with international auditing standards.

Preparation of financial statements in accordance with IFRS and audited by an independent auditor positively affects any family company as it increases transparency in financial reporting and accountability.

The Draft Turkish Commercial Code, which is expected to become enacted soon, requires the conformity of all accounting systems and financial reporting in all capital companies, public or non-public, with the Turkish Accounting Standards, which is a translation of the IFRS. In addition, preparation of consolidated financial statements has become compulsory in this context.

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Türkiye Kurumsal Yönetim Derneği
Corporate Governance Association of Turkey

Governance Guide for Family Companies

"IN THE LIGHT OF CORPORATE GOVERNANCE PRINCIPLES"

This guide is a product of the concerted efforts of the Corporate Governance Association of Turkey in order to familiarize family companies, which are among the cornerstones of the Turkish economy, with corporate governance principles. The process has taken advantage of feedback received from other publications which we had prepared for the information of our companies in the past as well as experience obtained from the programs that we organized in 18 provinces of Anatolia. We offer this publication for the benefit and instruction of our valuable executives.

During the preparation of the work, the needs of various sized corporations were examined through nation-wide research, and their common points compared with analogous institutions in various other countries. Beginning with the assumption that various sized corporations have needs of various degrees, the Guide provides various solution suggestions by virtue of the categories offered.

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