Talking Points

Value added by internal control

Results of a European survey

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Poor risk management, lack of regulation, and financial crime and corruption within large corporate organisations have recently been the focus of much media attention and intense public debate. The global economic climate has made it more difficult for firms to allocate significant resources and funds to addressing these issues.

As a consequence the value of internal control will come under greater scrutiny as managers look to streamline processes. These efficiency drives will inevitably result in the removal of controls from operations and lead to the potential for greater exposure to errors or fraud. Besides the obligation to comply with legal stipulations the question arises whether an effective Internal Control System (ICS) really adds value to a transaction or company sale for the company and the investors, and whether this value can be quantified. In the course an international study transaction services and risk management viewpoints are brought together for the first time. The objective was to identify precise value drivers of an ICS and to establish the value added by internal control.

Background and initial position

The European legislator has obligated market-oriented companies, in accordance with Article 46a Abs. 1 c) of the amending directives of the European Union, to describe the principal characteristics of an Internal Control System (ICS) with regards to the financial reporting process. The configuration and implementation of an ICS is therefore of increasing importance for European companies. A functional ICS minimises and prevents risks, allowing companies to achieve their strategic and subordinated objectives via its monitoring and risk control function. An ICS can prove a significant contribution to a company's future success.

In addition, an ICS helps companies to comply with regulations. Due to the lack of explicit legal regulations for non-listed companies, an inadequate risk culture and missing financial and human resources, many of these companies do not have a formalised ICS.[1]

The value added that can be generated for companies from an effective ICS is difficult to quantify. Besides the avoidance of losses as well as the seizing of opportunities, interactions with other management tools should also be considered. Beyond attempting to quantify the monetary value of an ICS, this report gives further insight into its practical relevance through outlining current opinion regarding its functionality and non-monetary value.

In order to be able to assume a common understanding of the terms "Internal Control System (ICS)" and "Value Added" between all inquired companies, the following definitions were given and taken as a basis for the survey:

Internal Control System (ICS)

The Committee of Sponsoring Organizations of the Treadway Commission (COSO)[2] defines internal control broadly as a process, affected by an entity's board of directors, management and other personnel. It is designed to provide reasonable assurance regarding the achievement of objectives in the following categories:[3]

1. Effectiveness and efficiency of operations
2. Reliability of financial reporting
3. Compliance with applicable laws

Value added

In this survey "value added" means the quantified value of an investment created by the willingness of investors to pay an extra amount for an existing and functioning ICS. This should lead to the fact that a formalised and documented ICS has a positive impact on the negotiations and pricing.

Approach and Methodology

This empirical study was conducted in 2011, in the form of a written questionnaire. 457 venture capital companies from six European countries were surveyed. The questionnaires could be answered from both the buyer's and seller's perspective. All companies were, at the time, reported to have active business operations and be a member of selected national associations:[4]

- Germany (Bundesverband Deutscher Kapitalbeteiligungsgesellschaften – BVKAP[5])
- Greece (Hellenic Venture Capital Association – HVCA[6])
- Israel (Israel Venture Capital Research Center – IVCRC[7])
- Poland (Polish Private Equity Association – PPEA[8])
- Spain (Spanish Private Equity and Venture Capital Association – ASCRI[9])
- Hungary (Hungarian Venture Capital and Private Equity Association – HVCA[10])

The most important statistics on the response of the study are summarized in the following table:

Table 1: Overview of statistics on the response of the study

Specifications	Buyers' Perspective	Sellers' Perspective
Location of the company (answering companies)	Germany: 44% Spain: 12% Poland: 6% Hungary: 9% Greece: 12% Israel: 17%	Germany: 48% Spain: 8% Poland: 4% Hungary: 12% Greece: 8% Israel: 20%
Number of transactions in the last year	1 - 5: 85% 5 - 10: 15%	1 - 5: 80% 5 - 10: 20%
Average amount of each transaction	€ < 10m: 59% €10m – 100m: 38% €500m - 1b: 3%	€ < 10m: 76% €10m – 100m: 20% €100m – 500m: 4%
Total amount of all transactions in the last year	€ < 10m: 47% €10m – 100m: 47% €500m – 1b: 3% € > 1b: 3%	€ < 10m: 60% €10 – 100m: 36% € > 1b: 4%
Industry sectors related to the transaction (multiple selection possible)	Mining: 3% Building and Construction: 18% Manufacturing: 38% Energy and Water supply: 9% Agriculture and Forestry: 3% Wholesale and Retail: 33% Hotel and Restaurant: 15% Logistics, Warehousing and Communication: 6% Banking and Finance: 12% Real Estate: 12% Education: 3% Healthcare and Welfare: 21% Others: 23%	Mining: 12% Building and Construction: 12% Manufacturing: 28% Energy and Water supply: 20% Agriculture and Forestry: 4% Wholesale and Retail: 20% Hotel and Restaurant: 0% Logistics, Warehousing and Communication: 12% Banking and Finance: 16% Real Estate: 4% Education: 0% Healthcare and Welfare: 16% Others: 12%

Results of selected questions in detail

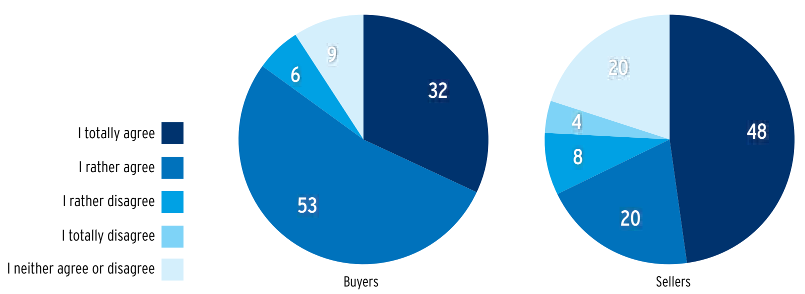
In the following the results of selected questions of the empirical survey are described in detail. Thereby the responses from both the buyers' and sellers' perspective are presented and compared.

A total of 85% of the interviewed buyer companies totally (32%) or rather (53%) agree with this point of view as well as 68% of the seller companies (48% totally agree and 20% rather agree). Only 6% of the buyers and 8% of the sellers rather disagree. Moreover, 4% of the sellers totally disagree. 9% of the buyers and 20% of the sellers neither agree nor disagree with the statement that a functioning ICS creates value for a company.

Figure 1: Value added by ICS

Value added by internal control

To what extent do you agree that a functioning Internal Control System (ICS) creates value for a company?



The results of the study show that companies are convinced that the establishment of a functioning ICS creates sustainable value. This raises the question what aspects companies consider to be the main value drivers of an ICS.

Buyers of businesses or parts of companies estimate "fewer negative surprises", with an Ø-rating of 2.82 (50% with high or very high priority), as a key value driver for companies with an established functioning ICS. The second most important value driver is "higher transparency" (Ø-rating: 3.03 and 50% with high or very high priority), followed by "higher financial stability" (Ø-rating: 3.53 and 44% with high or very high priority).

Sellers also see "higher transparency" within the company (Ø-rating: 2.25 and 60% with high or very high priority), "fewer negative surprises" (Ø-rating: 2.56 and 58% with high or very high priority) and "higher financial stability" (Ø-rating: 3.36 and 36% with high or very high priority) as the most important value drivers of an ICS.

The results of the companies surveyed have a similar structure on the buyers and sellers side. In practice, several aspects are attributed to ICS as a value driver, since no single aspect stands out clearly in its priority from the other aspects. However, the aspects "fewer negative surprises" and "higher transparency" slightly stand out against the other aspects. It is questionable if companies in fact are willing to pay for the value added through an ICS and the identified value drivers in terms of a transaction.

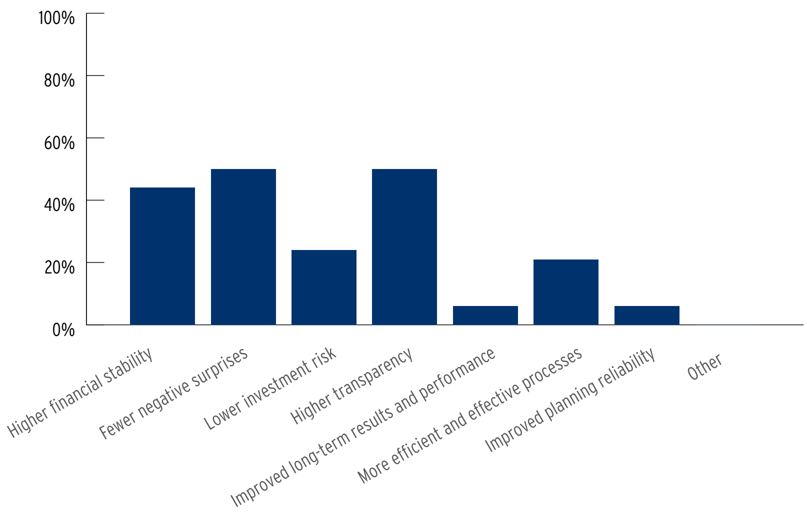
Figure 2: Value drivers of ICS

Value drivers of ICS

Which aspects do you consider as the most important value drivers for buyers, if a reliable and functioning Internal Control System (ICS) is in place?

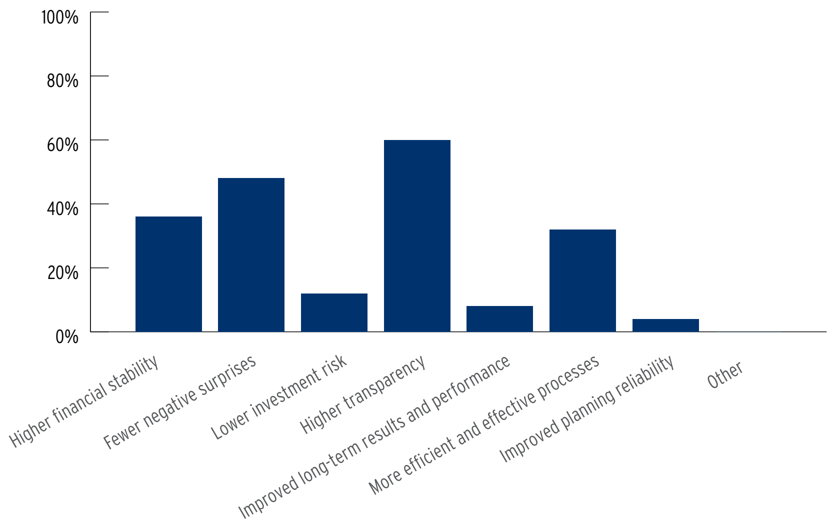
Buyers

Ø-rating: **3.53** | **2.82** | 4.35 | **3.03** | 4.85 | 4.29 | 5.24 | 7.00



Sellers

Ø-rating: **3.36** | **2.56** | 4.52 | **2.25** | 4.88 | 3.56 | 5.48 | 4.00



59% of buyers (18% totally agree and 41% rather agree) and 76% of sellers (32% totally agree and 44% rather agree) believe that it is worthwhile to pay/or charge a price surcharge for an established functioning ICS. 35% of buyers rather disagree (23%) or totally disagree (12%) with this statement. 24% of sellers rather disagree (20%) or totally disagree (4%). Only 6% of buyers are undecided on this question ("I neither agree nor disagree").

The majority of companies inquired are convinced that it is worthwhile to pay/or charge a price surcharge for an established functioning ICS. In this context an issue at stake is the amount of the surcharge companies are willing to pay (i.e. the quantification of value added in % of the total transaction volume).

29% of the buyers and 40% of the sellers consider a surcharge of 1-5% of the transaction volume as appropriate. 18% of buyers and 28% of sellers estimate a surcharge of 5-10% to be acceptable. 3% of buyers & 4% of sellers believe surcharges of 10-15% of the overall transaction value to be a suitable amount.

29% of buyers and 16% of sellers are willing to pay/charge a price surcharge of less than 1% of the total transaction volume. 21% of buyers would not pay a surcharge for a documented and functioning ICS, whereas only 12% of sellers would not charge an extra amount.

The results of the study show that companies are willing to pay/charge surcharges of up to 15% of the transaction volume for an established and functioning ICS. With regard to the average transaction volume of responding companies specified in chapter 2 it becomes evident that significant amounts of money would be spent for this purpose. Consistently companies should be willing to invest financial resources in the separate evaluation of an ICS in terms of a Due Diligence Process already in preparation of a transaction.

Figure 3: Price surcharge for ICS

Price surcharge for ICS

To what extent do you agree that a documented and functioning Internal Control System (ICS) justifies a price surcharge when purchasing/selling a company?

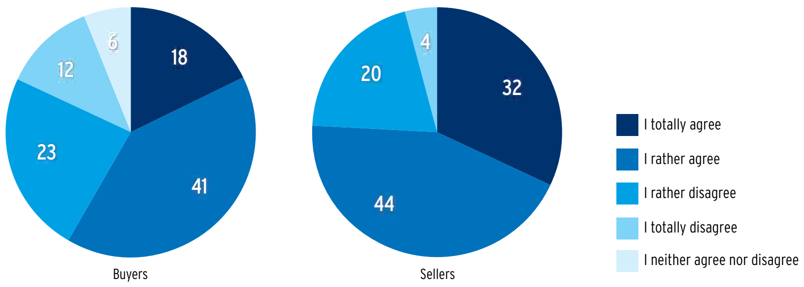
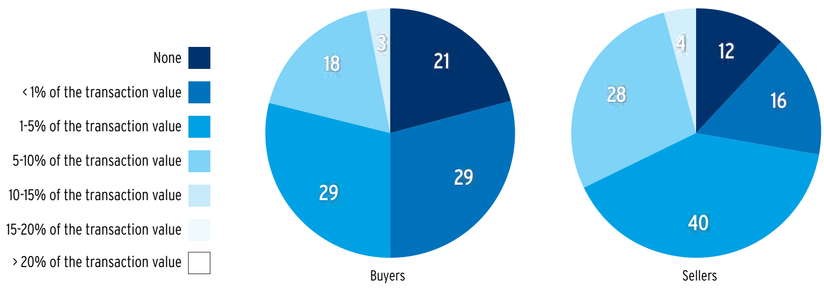


Figure 4: Percentage/Portion of transaction volume

Percentage/ Portion of transaction volume

How much extra would you be willing to pay/demand for a documented and functioning Internal Control System (ICS)?



The majority of companies, in total 71% of buyers, (15% totally agree and 56% rather agree) and 76% of sellers (40% totally agree and 36% rather agree), evaluate a separate assessment as useful for better decision making.

20% of buyers (14% rather disagree and 6% totally disagree) and 20% of sellers (16% rather disagree and 4% totally disagree) disagree with the statement that a separate evaluation of the Internal Control System in terms of an ICS-Due Diligence enables better decision making. Undecided in this question ("I neither agree nor disagree") are 9% of buyers and 4% of sellers.

The results of the study demonstrate that companies both from the buyers' and sellers' perspective are in favour of a separate due diligence process for evaluating their ICS. In this context the estimated willingness to invest was evaluated as well.

The survey reveals that 29% of buyers and 36% of sellers are willing to invest 1-5% of the Due Diligence Volume on a separate assessment of an ICS. Another 29% of buyers and 36% of sellers specify that 5-10% of the total Due Diligence Volume could be invested in a separate assessment of an ICS. 9% of buyers are even willing to invest 15-20% of the total Due Diligence Volume.

21% of buyers and 16% sellers would spend less than 1% of the total Due Diligence Volume. Only 12% of both buyers and sellers would spend no financial resources for an ICS Due Diligence.

The majority of respondents (88% of both buyers and sellers) are willing to spend financial resources on an ICS Due Diligence. To verify the predominant willingness to invest- both in terms of the transaction and in preparation of the Due Diligence process - companies were asked for their readiness to invest in an ICS subsequently, if no such system is established or the established one could be improved.

Figure 5: ICS Due Diligence (ICS DD)

ICS Due Diligence (ICS DD)

To what extent do you agree that a separate evaluation of the Internal Control System (ICS) in terms of an ICS-Due Diligence enables better decision making?

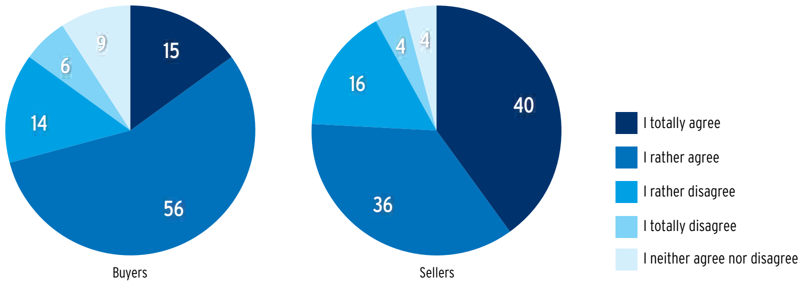
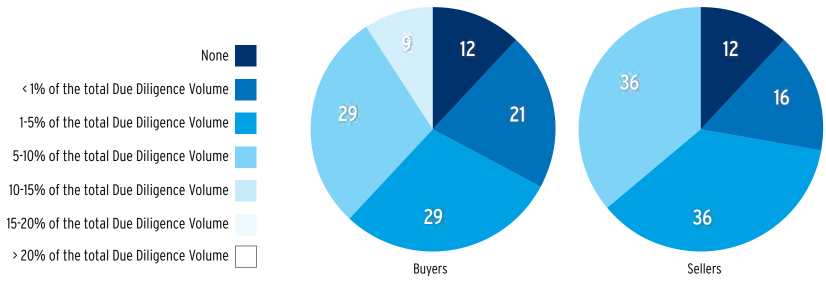


Figure 6: Percentage/Portion of Due Diligence Volume

Percentage/ Portion of Due Diligence Volume

Which percentage of the total Due Diligence Volume for a transaction may be due to an Internal Control System (ICS)?



The study shows that 82% of buyers (29% totally agree and 53% rather agree) take an investment in a functioning ICS into consideration, if no such system is established in the acquired company. 68% of sellers take such an investment into account (20% totally agree and 48% rather agree).

These results regarding the willingness to invest in an ICS - particularly on the buyers' side - illustrate the potential of realising a surplus value in transactions if a functioning ICS is already in place before the transaction. Only 15% of buyers (12% rather agree and 3% totally disagree) and 32% of sellers (28% rather agree and 4% totally disagree) negate their willingness to invest in case that no ICS is in place. Undecided on this question ("I neither agree nor disagree") is only a small percentage of buyers (3%).

The buyers' willingness to invest in a functioning ICS reveals the potential to realize additional value, if no such system is established in the acquired company. For better assessing the willingness to invest companies were asked to further specify the extra payment that could be invested.

The results from buyers' and sellers' perspectives are similar. 35% of buyers and 32% of sellers would spend 1-5% of the transaction volume. 5-10% would be invested by 18% of buyers and 12% of sellers. 4% of the sellers would be willing to pay 10-15% of the transaction value for the development and upgrading of an ICS.

38% of buyers and 36% of sellers are willing to invest less than 1% of the transaction volume Only 9% of buyers and 16% of sellers are not willing to invest in a functioning ICS.

Companies would spend up to 15% of the transaction volume on the implementation of an effective ICS. Those results correspond with the results of the question on the willingness to invest in an ICS and the amount of the extra investment. This emphasizes the conclusion that an ICS generates additional value for a company and that this value can be quantified in the course of a transaction.

Figure 7: Willingness to invest in ICS

Extra investment in an ICS

To what extent do you agree that extra investment in an Internal Control System (ICS) is necessary if the acquired/sold company does not have a functioning ICS?

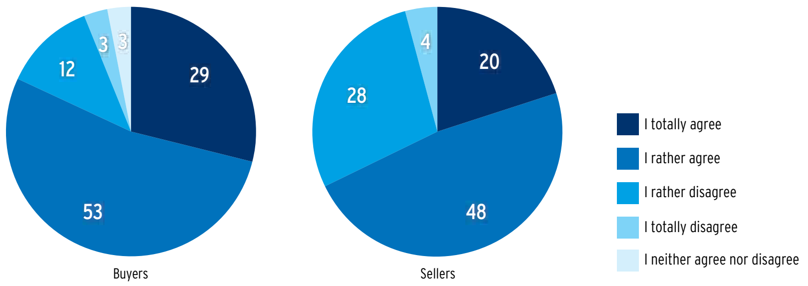
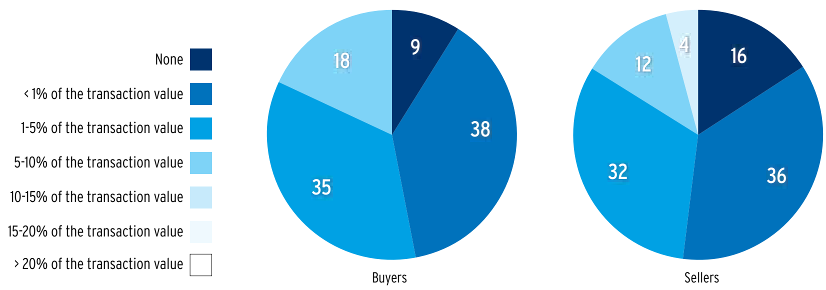


Figure 8: Percentage/Portion of transaction volume

Percentage/ Portion of transaction volume

What amount would you be willing to spend on the investment in an Internal Control System (ICS)?



Executive summary and recommendations for action

Companies do recognise the potential value add offered to businesses through an ICS. In many cases companies are willing to invest a significant percentage of the transaction value in the development of an effective ICS. Moreover, the payment of a surcharge price for an effective and documented ICS is considered a realistic option by many companies.

Most companies believe that a functioning ICS can generate additional value. Both investors and sellers of enterprises show their readiness to invest financial resources, or charge surplus prices ranging between 1-15% of the transaction value, to implement an ICS or for an established ICS.

Highlights of the survey, balancing buyers' and sellers' responses, related to a reliable and functioning Internal Control System (ICS) can be summarised as the following:

- 78% of companies agree that an ICS adds sustainable value, with "fewer negative surprises" and "higher transparency" quoted as the most important value drivers.
- 66% of companies agree that a price surcharge, in some cases of up to 15% of the transaction value, is justified for an ICS.
- 73% of companies agree that an evaluation or ICS-Due Diligence should be carried out, with 88% of companies willing to invest sums ranging between 1-20% of the total due diligence value.
- 76% of companies agree that an extra investment into an ICS might be necessary after the transaction and are willing to spend sums of up to 15% of the total transaction value.

The results of the survey, as well as day-to-day business experience, have led to the following conclusions and recommendations for creating value from an Internal Control System (ICS):

- **Formalisation and documentation:** With minimal effort, the existing controls can be formalised and transferred into a fully documented ICS with quantifiable added value.
- **Use of a recognised framework as a basis:** A recognised framework facilitates the understanding and the systematic structure of an ICS and helps to standardise controls.
- **Control culture as a key success factor:** The involvement of senior management as well as their control over the business can affect a company's culture and can, therefore, impact upon the success of a company.
- **Importance of an ICS-Due Diligence:** An ICS-Due Diligence can be used as the basis for all further evaluation processes; it underpins the integrity of information held by a company and supports decision making.
- **Value adding potential of an ICS:** An ICS can add value to a business either in the form of non-monetary benefits, such as the establishment of an effective management system, or in creating additional revenue as part of a corporate transaction.
- **Use of an ICS as a control instrument:** From an economic point of view, implementing an ICS is particularly helpful when used as a control and management tool instead of being limited to control and monitoring functions.

This article includes only a selection of the most important questions and is merely a summary of the main results of the study. The full results and further information on the study "Value added by internal control" can be obtained from RSM Germany or RSM International (email to: gregor.strobl@rsmgermany.de or rsmcommunications@rsmi.com).

Footnotes:

[1]Similar in their results probably Hiendlmeier, A. und Meier, B.: Das Interne Kontrollsystem: Pflichtübung oder Steuerungsinstrument?, in: ZIR 3/2009, S. 119-123.

[2]Cf. for a particular description of an ICS according to COSO e.g. Bungartz, O.: Handbuch Interne Kontrollsysteme (IKS) – Steuerung und Überwachung von Unternehmen, 3. Aufl., Berlin, 2012.

[3]Cf. Committee of Sponsoring Organizations of the Treadway Commission (COSO) (Ed.): Internal Control – Integrated Framework, New Jersey 1992, S. 13.

[4]Geographically speaking, Israel does not belong to Europe. However it is member of several European organsations. Especially in international or European sporting- and cultural events Israel is considered European and for this reason is included in this study. Cf. referring to this e.g. membership of Israel in the UEFA.

[5]For further information on Bundesverband Deutscher Kapitalbeteiligungsgesellschaften (BVK) cf. homepage at www.bvkap.de.

[6]For further information on Hellenic Venture Capital Association (HVCA) cf. homepage at www.hvca.gr.

[7]For further information on Israel Venture Capital Research Center (IVCRC) cf. homepage at www.ivc-online.com.

[8]For further information on Polish Private Equity Association (PPEA) cf. homepage at www.ppea.org.pl.

[9]For further information on Spanish Private Equity and Venture Capital Association (ASCRI) cf. homepage at www.ascri.org.

[10]For further information on Hungarian Venture Capital and Private Equity Association (HVCA) cf. homepage at www.hvca.hu

[11]Priorisation of the aspects by surveyed companies on a scale from 1-8, with 1 being considered highest and 8 considered lowest priority. Graphic presentation: Percentage of all inquired companies that assigned priorities of 1 or 2 to the respective aspect

Literature:

Bungartz, O.: Handbuch Interne Kontrollsysteme (IKS) – Steuerung und Überwachung von Unternehmen, 3. Aufl., Berlin, 2012.

Committee of Sponsoring Organizations of the Treadway Commission (COSO) (Ed.): Internal Control – Integrated Framework, New Jersey 1992.

Hiendlmeier, A. und Meier, B.: Das Interne Kontrollsystem: Pflichtübung oder Steuerungsinstrument?, in: ZIR 3/2009, S. 119.

RSM Survey „Value added by internal controls ", 2012.

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Oliver is partner and the national Head of Enterprise Risk Management (ERM) service line of RSM Germany, where he provides internal control, risk management, internal audit as well as compliance and corporate governance solutions to a variety of organizations.

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Gregor is a Manager in the Enterprise Risk Management (ERM) service line of RSM Germany. He has considerable experience in the implementation and on-going monitoring of risk management and internal control (SOX) projects for middle market companies and international corporations based on the worldwide known and accepted COSO frameworks (COSO I and COSO II / ERM) as well as on ISO standards for risk management.

He has deep experience in serving clients in the field of risk management services as well as other special services (e.g. Internal Audit, Compliance Management, Fraud- and Forensic Services).

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