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Private company governance

Independent board members can be a valuable resource for private companies

Entrepreneurs are typically strong willed people, and for many the thought of having to answer to similarly strong willed independent board members about the decisions they make for their businesses is not particularly appealing. They may also believe the cost, time, and effort required for a board with independent members could be put to better use elsewhere in their businesses.

Despite that, a growing number of privately-owned companies have opted to have boards with independent board members, believing that the perspectives and insights that they can bring to the company far outweigh any constraints. While some companies choose to include independent board members on their board of directors, most appoint them to a board of advisors.

Benefits of a board

Being the CEO of a private company or family-owned business can be a lonely position, and they can benefit from having a group of people with whom they can share ideas and perspectives. Independent board members may also bring a different and wider range of perspectives to the CEO than are typically found in a privately-held and family-owned business.

However, independent board members should be much more than just a sounding board for the CEO.

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Independent board members could bring knowledge and expertise in areas where the CEO's and management team's knowledge may be lacking, such as internal controls, finance, human resources, marketing, tax, and other areas. Independent board members may also have important industry expertise and first-hand experience gained from working with other organizations facing difficult challenges, such as a cyber attack or managing a crisis.

A board also helps private companies build trust with other organizations, since a board extends the accountability for the company beyond just the CEO. For this reason, some lenders require private companies to have boards as a condition for extending financing; many lenders are likely to look more favorably on private companies with a more robust governance structure. Similarly, a board may be a signal to customers and suppliers that they are doing business with a reputable organization that will be sustainable over the longer-term.

As a private company grows, the owner's role will change, as will its management processes. In smaller start-up companies, owners usually take a hands-on role. Processes throughout the organization are informal; since the owner is involved in most activities, he or she has a first-hand knowledge of almost every aspect of the business. As the company grows, new people are added to the team and the owner's role becomes more of a manager, and the need for more formal processes, knowledge sharing and delegation increases. Experienced board members can guide CEOs as their role changes and new processes are implemented, and can also offer assistance in developing a shorter- and longer-term strategic direction for the company.

Independent boards can also help family-owned businesses manage one of their biggest challenges: succession. This is one area many family-owned businesses avoid addressing since it involves a complicated mix of family and business concerns. Owners want to do what is best for the business while also treating all family members fairly and avoiding family infighting. Family members may have conflicting expectations about the roles they feel they should play in the family and the business, which they may perceive as a right. The presence of a board simplifies the succession process. When the board is responsible for identifying a successor, it removes many of the personal issues from the process; the successor will be selected based on merit, rather than family position. The owner, meanwhile, can address family issues without them becoming mixed with succession.

Types of boards

While in many respects the responsibilities of a board of advisors and a board of directors are similar, there are some distinct differences. As its name suggests, a board of advisors acts as a sounding board for management, and while it may provide input into a variety of issues, the CEO may choose to either accept or ignore any of the board's suggestions.

Private company governance structures:

Board of Advisors – Advises the CEO and management team. Members of the board may include the owner and members of his/her family, and/or company employees, and/or people who are independent of the company. (The ratio of independent board members to employees to family members will vary depending on the circumstances of the company and the owner's comfort level in working with independents.) The suggestions and recommendations of the board are provided as advice to the owner and management team and are not binding.

Board of Directors – The role and membership of a board of directors are similar to that of a board of advisors, however the decisions of a board of directors are binding.

Family Council – A family council normally works in conjunction with the company's board. The council's role is to oversee the family interests in the business. It also provides a forum where family matters can be discussed away from non-family members of the board of advisors or board of directors. Members of the council are restricted to the owner's family, though there may be ex-officio (non-voting) members, such as legal counsel, to advise on specific issues. The protocols of a family council are usually set out in a family charter, which provides a family vision and mission statement and ground rules for council meetings.

A board of directors has a fiduciary responsibility to the company, and is required to consider the greater good of it and all of its stakeholders—as well as its progress towards strategic goals. The board, therefore, will provide oversight of management and will make sure management is keeping the best interests of the company in mind. A board of directors' decisions are usually binding on the company's management. (However, since the board is responsible to the company's shareholders, the shareholders—either the sole owner or the group of owners—have the authority to dismiss the board.)

Role, responsibilities and structure of the board

As with boards of public companies, the role of a private company board is one of oversight. Many of the specific responsibilities of a private company board are also essentially the same as those of a public company board, including but not limited to, oversight of strategy, reviewing the company's financial performance, ensuring that risks to the company are identified and mitigated appropriately, ensuring that a succession plan is in place for the CEO, etc.

Because their roles and responsibilities are similar, private company boards should adopt leading practices of public company boards. However, a private company board will often need to adapt or scale some of those practices to suit the company's specific circumstances; most private companies, for example, won't have an internal audit department so a private company board's responsibilities with respect to an internal audit function may differ. Similarly, since private companies are usually much smaller than public companies, their boards will also likely have fewer members and may not need the same number and diversity of board level committees as a public company board.

Often, independent board members are asked to provide their expertise and experience to augment management's skills and knowledge in certain areas. (In doing so, they should act as advisors to management, but should not manage activities themselves.) Because of their smaller size, however, the board may not have deep expertise in every area where it's needed. A common practice is to invite outside experts to address the board on matters where the board members could benefit.

Transparency and reporting

Most private companies don't have the same requirements to disclose financial and other company related information as do public companies. However, transparency is just as important for private companies. It is particularly important in the case of family businesses, which should have the same level of transparency with the family stakeholders as a public company has with its shareholders. Transparency can help reduce misconceptions and conflicts among family members.

Private companies should consider publicly disclosing information about their activities and governance practices that provide them with a competitive advantage—for example, if those activities will lead to better financing conditions, better arrangements with suppliers, increase in their customer base, etc. They may also want to disclose information about their ethical practices and sustainability activities since these issues are important to private company stakeholders and the disclosures can help the company enhance its reputation.

Qualities of board members

Since the owner's close friends and associates will share many of the business owner's viewpoints and experiences, companies should look outside that circle when recruiting independent board members. That's because a key benefit of having independent board members is their different and diverse perspectives, as well as their ability to augment the business owner's own knowledge and expertise with their own different backgrounds and experience.

As with all boards, education is important since board members will need to keep pace with the business's needs as it evolves, its industry changes, and new challenges arise. The board and each of its members should be evaluated every year to ensure that they continue to meet expectations, and that their skills keep pace with the changes and growth of the organization.



Daniel Aguinaga

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"Governance should add value to the organization. Private companies that view the board as an instrument of accountability, growth, and strategy will realize that value. The wealth of knowledge and experiences that independent board members have can enhance the owner's own skills and capabilities, and their different perspectives may bring owners a range of new ideas and approaches to strengthen the company." – Daniel Aguinaga

An independent board member's perspective



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Are private companies in Mexico encouraged to have independent board members?

Mexico has a large number of private companies, and the government, universities, and other groups are encouraging them to improve their governance practices by creating an independent board of directors. That's a difficult step for people who have owned and managed a business very successfully. For many of them, it's a gradual process. At first, they may appoint a single independent board member, and when they become comfortable with that, they may add more of them.

At some point, however, the independent board members and the owners will disagree on a strategy or some other item. That is usually the test of how committed the owner is to having independent members of the board.

I've worked with several private company boards. The owners need time to learn how to work with independent board members, and the independent board members—especially people serving on a board for the first time—need time to learn how to work with the board and with the owners.

What advice would you give to someone who is asked to serve on a board?

Before agreeing to join a board, it's important to do some research about the company, its board (if it currently has one), and the owner.

You need to learn about the company's financial situation, its business situation, and the key issues the company and the board are focused on. Is this a company you want to become involved with and do you have the experience in the areas where it is needed by the company?

It is also important to understand what kind of board the company has and what its role is. For example, is the company establishing a board for the first time, or does it already have a board with a mature governance process? If it has a board, what does the company expect from the board and from the individual board members? Is the board stable or is there a high turnover rate among its members? You want to be sure you are joining a board where your opinion as an independent board member is seen as having value.

Another important consideration is why the owner wants to have independent board members and how well the owner works with them. Does the owner believe independent board members will help make the company successful, and is therefore willing to work with them and the board? Is there an attitude of mutual respect between the owner and the independent board members? If the owner wants them on the board for another reason—perhaps just to gain industry insights or knowledge—that may indicate the owner isn't willing to share key information with the board or accept its advice.

How well understood is the independent board member's role on a private company board?

There can be confusion about the role, so it is important that independent board members establish clear ground rules. When they first join the board, they need to clearly communicate to the owner and the other members of the board that they will provide advice and guidance, and they will be open and honest in their recommendations, but that they are also independent, which means they may not always agree with the owner.

If independent board members don't make this clear from the start, or if they try to play a social or collegial role on the board, the owner won't consider them as being independent. That will be a problem when an independent board member disagrees with the owner. Owners may accept some disagreements over minor decisions, but if it is something larger—for example, a strategic decision—the owner will not accept a challenge from a board member who isn't understood to be independent.

What should independent board members do to build a good working relationship with the owner?

First, as I just mentioned, they need to set clear ground rules about their independence. Next, they need to understand that they are part of a process. They aren't going to change everything all at once. Instead, they will need to take things step-by-step, address some key issues today and then, at the next meeting, they can focus on moving something else forward.

It's also important that independent board members do not try to present themselves as experts with the skills and knowledge to make all of the decisions on a subject. A mistake made by many new board members—especially people with a lot of business experience but no previous board experience—is not limiting themselves to providing oversight and advice to the owner, but actually attempting to manage the company.

It takes time for boards and independent board members and owners to learn how to work together. In my experience, business owners are willing to consider an independent board member's recommendations as long as they are given time to think about them and the board member respects the owner's position, including the fact that, ultimately, he or she has the final decision. For their part, it takes courage for an independent board member to challenge a business owner; they need solid evidence and arguments to support their position, and they need to be clear that the analysis and advice they are providing is given in the best interests of the company.

Where can independent board members make their biggest contribution?

A lot will depend on the position of the company and the board member's own knowledge and expertise. In general, though, many private companies are weak in strategic thinking and need a strategic process. Many business owners make decisions based on what worked well in the past; they're not used to looking at things in a different way or following a strategic planning process to identify the best future direction for the company. This is where independent board members can play an important role.

Another challenge for private companies is talent and developing the people the company will need in future. That's because many private companies are staffed by the owner's family and close friends. While they have existing relationships with the owners, and may be very good at what they do, they often don't have all of the necessary skills. Because of this close relationship, the owner may not recognize that they lack expertise in a certain area, so the board can provide oversight and guide management on addressing talent concerns.

One of the biggest "people" issues for a private company is succession. How can the board help?

Succession in a privately held organization can be challenging for both the business owner and the board. For business owners, succession is extremely personal, and often they don't want to address it until it can no longer be ignored. Then, if they haven't developed someone in the family with the skills to continue running the business, the situation is very difficult to manage.

Because succession is such a difficult process for many owners and their families to discuss, independent board members should create a communication system outside of the board itself. Perhaps, they will begin working with just one or two members of the family before taking the issue to the full board. That way, important but difficult issues, like succession, don't need to be discussed in front of everyone, but instead can first be presented and discussed in a smaller group. Creating the right communication system with smaller meetings where the director can gain the confidence of the owner and the family is important when matters need to be addressed.

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To read our previous *On the board's agenda* issue focused on Base Erosion and Profit Sharing, and to receive upcoming issues, please contact us at DTTLglobalcenterforcorporategovernance@deloitte.com

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