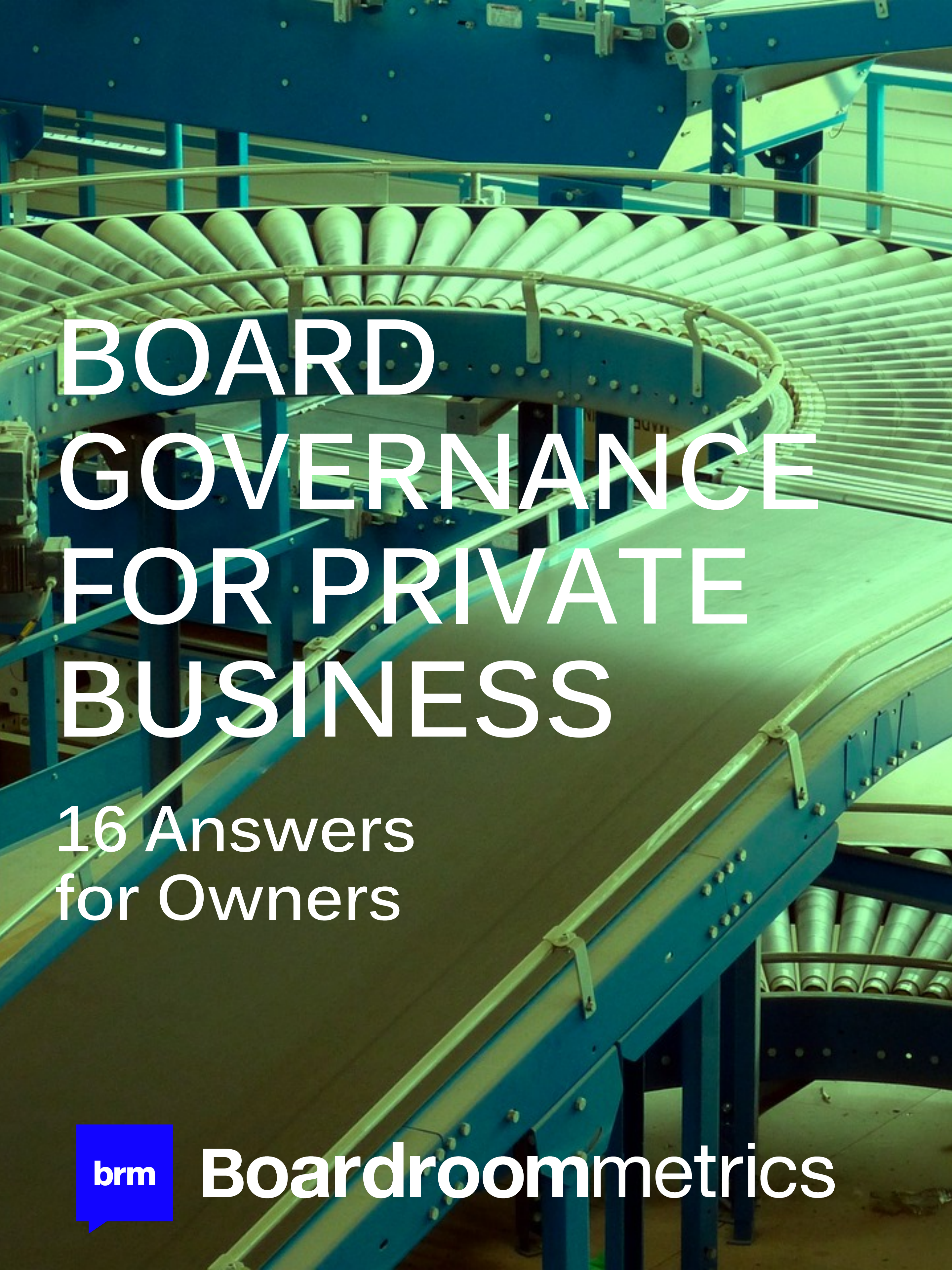
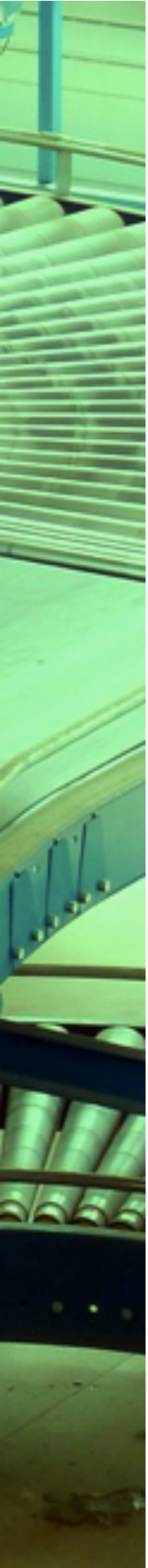


BOARD GOVERNANCE FOR PRIVATE BUSINESS

16 Answers for Owners

Boardroommetrics



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Introduction

Why do private business owners care about Board Governance? These four reasons are common:

“I’m thinking of selling my business.”

“I want to protect what I’ve built.”

”My business is good but I want it better.”

”Someone told me I should look into forming a Board of Directors.”

Whether it’s to build a better business or sell a great one, a Board of Directors can help. Expertise and accountability are good things to have.

However, not every private business needs a Board and a Board doesn’t work for every private business.

The sixteen questions in this eBook represent the most common questions we hear private business owners asking. We’ve kept the answers simple because when Governance gets complicated it is not as effective. Hopefully you will find the direction helpful.

Jim Crocker, Chair

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1. What is Board Governance?

Board Governance is the oversight approach that Boards of Directors use to ensure management runs the business successfully. Often, it is called Corporate Governance.

There are three elements of Corporate Governance:

- identifying legal, financial, market and operating risks to the business
- approving a strategic plan for mitigating keys risks and executing the organization's mission
- holding the CEO accountable for executing the strategic plan.

Boards that provide Corporate Governance oversight are called Governance Boards.

Compared to Advisory Boards, Governance Boards are more accountable. The role of advisory Boards is solely to provide advice.

Compared to Operating Boards, Governance Boards are more objective. Operating Boards mix oversight with running the business.

Public companies all have Governance Boards. Private companies, associations and not-for-profit organizations have a mix of various Board types.

“Board Governance is the process Boards use to oversee risk, strategy and performance of the organization.”

2. Benefits to private business?

Objectivity and accountability are the primary benefits of Corporate Governance for private business.

Objectivity – which is achieved by adding outside Directors to the Board and staying away from making day-to-day operating decisions – helps ensure that the organization's assessment of risk, strategy and performance is not compromised by personal interests and limits on expertise.

Accountability – which the Board achieves by approving plans and measuring results – helps ensure Management execution. Successful private business owners especially, agree that their businesses are stronger when Management is more accountable.

Corporate Governance is particularly helpful as a business matures and two things happen – the business becomes more complicated; and, succession becomes a priority.

Strong Corporate Governance provides clarity, confidence and performance. It drives more successful businesses – and owners.

“Objectivity and accountability are powerful tools in the drive for greater performance.”

3. Too small for Governance?

A two-person firm likely does not need a Board of Directors.

However, if the owners of any size business take time to identify risks, plan strategy and hold themselves accountable, then they are still executing good Corporate Governance.

Ultimately, business goals are more important than size in determining whether a Board of Directors is necessary or not.

You see that in technology start-ups. Many of them have Boards. It’s the best way possible for funders to ensure founders are accountable for achieving the impressive results they have promised.

“No business is too small for Corporate Governance.”

4. A trend to more Governance?

The dominant trend in private business has always been to adopt Corporate Governance when an organization seeks funding or in preparation for an exit.

Owners have long recognized that funders and buyers appreciate the business and financial clarity that strong Governance provides. Not surprisingly, private businesses with strong Governance are worth more.

According to a 2014 study by McKinsey, over 75% of investors are prepared to pay a premium of 18% to 30% for a well-governed business.

Now, with boomer-owners retiring, there is an overall trend to more Corporate Governance. The goals are to attract buyers and maximize value – two things that are more challenging in an environment where there are more businesses for sale.

“Private businesses with good Governance are more valuable.”

5. Key Governance Roles?

There are two key roles that make a private business Board of Directors effective.

The first is the role of independent Directors. Directors are independent when they don’t have any personal or financial ties to the business. This enables them to think and act independently of those who own and operate the business. The objectivity this provides is crucial to strong Governance.

Second is the role of an experienced Board Chair. Having a leader who understands Governance process is critical.

Otherwise, it is almost certain that the Board will have difficulty staying focused on its oversight role. To be effective, the Board Chair must have the respect and trust of the owners.

“An experienced Board Chair and outside Directors are the most important roles on a private business Board.”

6. What are some best practices?

Getting clear on the role of the Board is first.

There's a big difference between a Board that operates the business (an Operating Board) and a Corporate Governance Board. Defining the Board's role will impact the Board's composition (who's on it) and how it operates.

Another critical best practice for a Governance Board is defining how the Board will work with the CEO.

Separating the Board and CEO function is a Governance best practice. The CEO reports to the Board and the Board is responsible for setting and monitoring how the CEO performs.

“Governance (the Board) and operations (the CEO) are different roles. Separating them is an important Governance best-practice.”

7. How to start?

Begin by defining the Board's role. It's important for the owner to answer the question 'why do we need a Governance Board?'. If it is primarily advice the owner is seeking, perhaps an Advisory Board is more appropriate.

Next, define who will lead the Board. That's the Board Chair (or Chairperson, Chairman, Chairwoman).

With the Chair's input, establish criteria for selecting Directors who will make the Board most effective.

The skills and expertise of the Directors on a Governance Board should reflect the risks the business is facing and the strategies it is executing to achieve its mission.

The Board skills matrix is a simple, helpful way of identifying expertise gaps on a Board. The example on the next page shows that there is a skill gap in technology on the Board. It also shows that Director 'D' does not have clearly defined reason for being on the Board.

Board Skills Matrix

	BOARD LEADERSHIP	PRIVATE BUSINESS	CORPORATE STRATEGY	TECHNOLOGY
Director A	✓	✗	✓	✗
Director B	✗	✓	✗	✗
Director C	✗	✓	✓	✗
Director D	✗	✗	✗	✗

Finally, decide on the Governance processes the Board will undertake to fulfill its Governance role. Begin by defining how often the Board will meet; what the Board meeting agenda will be; and, how the Board will make decisions.

“Female, cyber-risk, operations and digital management are the top backgrounds being recruited to Boards in 2020.” *2019 Spencer Stuart Board Index

8. How big a Board?

If a Board is too small, it risks having insufficient expertise to govern and/or operate effectively. A Board is definitely too small when less than three people are available for a Board meeting.

If a Board is too large, it risks becoming unwieldy and a challenge to lead effectively. There is no correlation between business size and Board size or between Board size and Governance effectiveness. There are only seven people on the Apple Board of Directors.

A key sign that a Board is too large is when it strikes an Executive Committee. Often Boards do this to streamline their Governance process. However, by concentrating key elements of Corporate Governance in the hands of a select few, the importance of other Directors is diluted. This is dangerous both from a Governance perspective and from a Director liability perspective.

“The ideal Board size is typically between five and nine Directors.”

9. How to find Directors?

Many Director searches begin within a Company's own network of friends and allies. It is an efficient and inexpensive way to identify and attract known talent.

There are also recruiters who specialize in Board searches.

On-line, there are web sites dedicated to helping Boards and Directors get connected so they can work together.

We do not recommend that Boards only seek new Directors from inside their network.

By looking elsewhere, Boards expand their talent pool and help ensure that new Directors are objective and independent.

Ignoring potential Directors because they lack Corporate Governance experience is an extremely common mistake that Boards make.

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“It’s easier to teach a cyber-security expert Governance than a Governance expert cyber-security.”

10. Compensation for Directors?

We observe greater Board effectiveness when Directors are compensated. There appear to be a couple of reasons for this:

1. Boards can set higher standards for knowledge and expertise when Directors are compensated.
2. Directors who are compensated tend to view their Board relationships from a more business-like (objective) perspective.

By compensating their Directors, risks can be eliminated that occur on volunteer Boards.

The first risk is having a ‘cause-driven’ Director. Because their cause is ‘worth it’, cause-driven Directors go onto Boards voluntarily. Cause-driven Directors are not objective.

The second risk is having a ‘voluntarily-entitled’ Director. In return for volunteering, these Directors expect to have their opinions acted upon. Entitled Directors are not objective.

Finally, it is possible to over-compensate Directors. Directors are over-compensated when they fear doing anything that might jeopardize their Board income. Over-compensated Directors are not objective.

“There is a risk that when Directors are under or over-compensated they are less objective.”

11. Owner as Board Chair?

Ideally, the owner should not be the Board Chair because the enemy of good Governance is lack of objectivity.

Private business owners are like anyone else - it's difficult being objective about things we're close to and care about.

Most owners are intimately involved with their businesses. They provide the leadership and they are responsible for whatever the results are. It is very difficult for them to be objective about the business. That limits their effectiveness as Board Chair.

In addition, Board Chairs who are intimately involved in the business easily influence the objectivity of others on the Board. Related Directors (Directors who aren't independent) are particularly vulnerable, especially if their non-Board role (employee, family member) makes it awkward for them to think or act independently of the Chair.

Finally, many owners simply lack the Governance expertise to lead the Board. Those who do are often the first to understand that they should not be leading their own Board.

“The Board will be more objective if the owner isn’t the Chair.”

12. Biggest pitfalls to avoid?

The biggest pitfalls to avoid in Corporate Governance are:

1. **Making the CEO the Board Chair**. It's impossible to hold the CEO accountable when they run the Board (Governance) and the business (Operations).
2. **Focusing too much on finance risk and not enough on external (market) and internal (operating) risks**. Large, high profile companies like Boeing, Volkswagen and Wells Fargo have all been hurt by failures to identify operating risks. Legal and financial pain came later.
3. **Focusing too much on operating risk**. Venturing too far into operations isn't the role of the Board. If the Board is highly familiar with the operation (owner, executive, advisor) then it's natural for the Board to focus on operations at the expense of other risks and strategies.
4. **Failing to understand the mission of the organization**. Mission defines who the Company's customers are and how the Company serves them.

Mission sounds simple but many well-established organizations are not clear on this (yes, that is surprising). It's important because everything the organization does (strategy and operations) flows from its mission.

If Directors don't share a consistent understanding about the Company's mission, then effective Governance is much more difficult.

"For Governance to succeed, it must be objectively focused across <u>all</u> risk, strategy and CEO performance."

13. Biggest struggles for owners?

The biggest struggle owners face is fear of losing control of the business.

It is closely followed by the the belief that no one else (especially an outsider) can possibly understand the business the way the owner does. For most owners, the thought of reporting to a Board - or anyone - is terrifying. It's not why they became entrepreneurs.

Also, many owners are dismissive of strategy.

From their perspective, strategy wasn't important for them to achieve their current success (this is often incorrect - many owners do strategy intuitively, if not formally). Seeing that strategy might matter in the future is hard for them to believe.

Although there are some high profile private companies that overcame these fears, the majority of private businesses never achieve their full potential.

They never reach their full potential because they are limited in three ways:

- **The owner is comfortable**. Going beyond the current scale and success of the business is not important.
- **The current business strategy has reached its limits**. Without some kind of change in direction, additional growth and success is impossible.
- **Leadership has reached its limits**. Without additional capacity, skills and expertise, additional growth and success is impossible.

Without awareness of these limits, getting comfortable with Corporate Governance is often difficult

“Corporate Governance is a disturbing concept for many owners.”

14. Overcoming these struggles?

Owners that implement Governance Boards frequently have goals beyond a successful business and a fulfilling lifestyle. Many owners already have both.

Maximizing the value of the business is one goal (typically in preparation for exit).

Maximizing the size and scale of the business is another.

Just as they have always done, owners adapt and overcome their struggles in order to achieve their goals. Often, that's when they open up to Corporate Governance. In fact, in the case of maximizing value, there may be no choice but to adopt a Governance-focused approach. Without it, buyers and investors may never perceive the value that the owner sees in the business.

However, implementing a Governance Board isn't just a logical means (build credibility) to a valuable end (exit). It's also recognition of the benefits of sharing accountability for success with others.

“Getting out of our own way can be helpful some times.”

14. Exit Considerations?

There are several ways to exit a private business: go out of business; transfer to a relative; sell; and, go public.

The last three all highlight the value of the business.

The reason well-governed companies are worth more is because future owners recognize and appreciate the formal rigor that strong Corporate Governance brings to a business.

First, rigor around identifying risks. Most businesses are overly focused on financial risk and blind to many market and operating risks.

Second, rigor around developing strategy. Many businesses struggle with strategy. Unclear on their mission, they confuse annual operating plans with longer term strategic priorities that create value.

Finally, rigor around operating execution. Most private Company CEO's we know have never had a performance evaluation.

That means there is only limited accountability.

Rigorous focus in each of these areas assures future owners that the business will perform as promised and provide the returns necessary for a profitable succession.

"Going out of business is a very disappointing way for an owner to exit."

16. Top Five Takeaways?

These are the five top take-aways we hope owners get from this eBook:

1. There are three elements of strong Board Governance. Any business that gets those three things right will be successful.
   - identify and mitigate risk
   - develop and oversee a strategy for executing the mission well/better; and,
   - performance-manage the CEO.

2. Failure to identify external (market) or internal (operating) risks is the most common reason organizations fail.

3. The skills and expertise of the Directors on a Governance Board should reflect the risks and strategies of the organization.

4. Lack of objectivity is the greatest enemy of strong Corporate Governance. For a private business Board to succeed it must introduce outside Directors.

5. It's natural for owners to fear loss of control. However, Corporate Governance executed properly protects owners and makes their businesses stronger and more valuable.

“Owners who implement a Governance approach are prepared for their own future.”

About Boardroom Metrics

Boardroom Metrics was founded over twenty years ago to focus on Boards and Corporate Governance effectiveness. Organizations call Boardroom Metrics when they need help with:

1) **Board Evaluations.** We use customized surveys, interviews and other assessment tools to evaluate how effectively public, private and not-for-profit Boards of Directors understand and execute their Board role.

2) **CEO Evaluations.** We use customized surveys, interviews and other assessment tools to evaluate the CEO's performance versus the Board's expectations, business objectives and personal development goals.

3) **Board and CEO Succession Planning.** We provide tools and consulting to help Boards develop criteria and processes for planned and unplanned succession.

4) **Governance Education, Consulting and Coaching.** We speak to/work with Boards, Associations, and other groups on Corporate Governance, the Board's role, and the processes and tools for executing Corporate Governance effectively.

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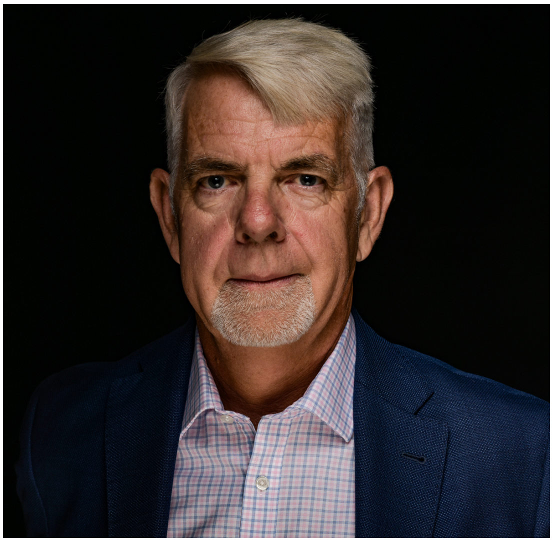
About The Author



Jim Crocker is the Chair of Boardroom Metrics. An accomplished Director, CEO and Consultant, Jim works with Boards of Directors of Public, Private and Not-for-Profit organizations in the US and Canada. His mantra - ‘risk, strategy and performance management of the CEO’ - helps keep Boards focused on Governance and out of trouble.

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