A look at private company governance

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Venture capitalist and board member shares his perspective

Bruce Golden of Accel Partners has been recognized as one of the top 100 venture capitalists in Forbes’ Midas List of tech investors. He also sits on the boards of several public and private companies. In a recent interview with EY, he shared his perspective as both a board member and investor, and explained how communication and measurement are the keys to good private company governance.

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Leading to succeed
Venture capitalist and board member shares his perspective

For the last three years, Bruce Golden of Accel Partners in London has been recognized as one of the top 100 venture capitalists in Forbes' Midas List of tech investors. He serves as Chairman of the Board of Qlik Technologies, which was one of the best venture funding success stories in European history, and has been a board member of a number of international companies, from early stage, through growth and IPO. He currently holds board seats on public and private companies, including Forgerock, MindCandy and Responsys. In a recent discussion with Bruce, he shared his perspective as both a board member and investor, and explained how communication and measurement are the keys to good private company governance. Following are excerpts of his conversation with AJ Jordan, the Strategic Growth Markets Leader for the East Central Region of Ernst & Young LLP.

AJ Jordan: What are some of the lessons you’ve learned that might help position private boards for success?

Bruce Golden: There are many. One that immediately comes to mind is that it’s important for all boards – but especially those of early stage companies – to anticipate issues, as the business and market dynamics can change rapidly. I think it’s very helpful for boards to openly discuss challenges that may be around the corner.

Similarly, boards need to get ahead of situations that can be anticipated with any reasonable analysis. It is important to measure everything that matters so you can anticipate issues and preemptively address them. Nothing is more frustrating than finding yourself in a difficult situation, looking in the mirror and saying, “I should have expected this was going to happen.”

Another lesson is, if there are known disagreements at a board level, work them out. Boards are organic systems with people and personalities, and there may be conflicts or diverging points of view. Don’t let things fester. If there are misalignments or disagreements about important matters, work them out or they can paralyze a company at critical junctures.

I also think you need to make sure that everyone has a chance to speak their mind. A danger on some boards is that you have a dominant personality that suppresses other views. It’s very important in high-performing boards that you hear from all the relevant voices at the table.

AJ: What skills or characteristics do you tend to look for when building out the board?

BG: We evaluate the needs of each individual company and then seek out board members who can make a major contribution in that particular situation. For example, there are times we may recruit a
product or technology executive with experience in building similar types of businesses because this executive can help shape the product road map at a pivotal stage.

Industry executives with experience in scaling similar businesses globally can also make good board members, as they can assist in recruiting, customer acquisition and partnership development.

There are also times when we might recruit for board members with more specialized experience, such as when staffing an audit committee in preparation for an IPO.

Serving on a board is not easy, so all outside directors have to be good communicators, collaborative and willing to take on difficult issues. It’s crucial you have independent directors prepared to confront important issues, such as decoding poor sales performance or evaluating a change in leadership. A board requires people who can speak the truth and be active members.

**AJ:** In the early stages of a business, do boards need to be focused on supporting the development of a strategy for this business?

**BG:** Yes. Good boards are constantly asking themselves where they can have the greatest impact on the business. As we often get involved with pre-revenue companies, our work as board members includes focusing on product strategy, clarifying the company’s market insertion point and building a repeatable sales model, creating operating leverage through various kinds of partnerships and recruiting for key roles.

Because we are primarily focused on early stage tech investing, we are not only board members but often also serve as the lead investor in a company. Our job at every stage, as board members and as investors, is to help our management teams be successful.

As investors, we are highly focused on outcomes. We look for companies where we see the potential for greatness. Because we often invest in very young companies, we know there’s going to be a long journey to help nurture them to an IPO or significant M&A outcome. In fact, our average investment period is greater than eight years.

As a venture investor, we are always minority owners in companies and, therefore, aligned with management to create a highly valued business. We really only win if the management team wins, so collaboration is crucial.

I think the most important words for an investor/board member to speak are “How can I help?” When I walk into a board meeting, I’m focused on, “Who can we help recruit? Which potential customers can we open doors to? What partnerships can we help facilitate?”
We really only win if the management team wins, so collaboration is crucial.

AJ: *What you describe sounds like the right benchmark for what early stage boards should look like.*

BG: I hope so. In many cases, we’re investing in a company with just one founder or a very small team, and we choose to do so because we think they are exceptional. However, it is not unusual to find that these teams can be asymmetric in experience and knowledge. Therefore, as we develop the company, we strive to build on strengths and fill in gaps where needed, with the ultimate goal of creating a high-performing, self-sufficient team. This allows the board to take on an increasingly strategic focus.

An important success factor for any company and board is the rate of learning. The companies that have been the most successful in our portfolio are the ones that have very high rates of learning and that have the ambition to pioneer a new market or reshape an existing one. These companies develop efficient feedback loops with customers and act on information quickly to enhance their product capability, their go-to-market strategy and overall market positioning. They are also adept at evolving their product offering to increase their strategic value over time.

AJ: *Can you explain what metrics the board should use to measure success?*

BG: It’s absolutely crucial that the board establishes clarity with the management team around what metrics to measure. Every functional area should have a health check.

As a board member, I usually ask, “What are the key milestones and objectives we need to evaluate at this stage of the company, and what is a logical time period to measure?” We often think in 6- or 12-month intervals, which are relatively short sprints to get to the next plateau.

I personally believe that everything that matters needs to be part of a dashboard. For example, I want to understand metrics on
whether we can hire and retain people effectively, or how quickly it takes a company to recruit a new salesperson and make them effective. The more data driven we can be as board members, the better.

AJ: What do you see as some of the similarities or differences between private and public company board service?

BG: Boards of private and public companies can function quite differently as they face different pressures and requirements. For instance, early stage company boards tend to be smaller and may not have the same formally staffed committees that are required for public boards. Additionally, there are typically more frequent board meetings and more contact between the board and management in younger companies, particularly in the venture-backed world. These more frequent and often informal touch points are crucial when the rate of change is dramatic, as is the case with most high-growth tech companies.

However, while smaller private company boards may be more informal, being small or young is not an excuse for being mediocre at governance or for not establishing a very high standard for internal reporting and analysis. There are a lot of things that venture-backed companies have to do exceptionally well, to position themselves to grow quickly and mature into category leading businesses. Good private boards are constantly probing into all areas of the business to ensure the right processes and analysis is in place to facilitate growth. When issues or surprises come up, these are usually great opportunities to understand areas of development that need to be addressed.

Transparency and rapid two-way communication are necessary success factors for any board. Management must be encouraged to bring problems and issues to the board in a timely manner.

Experienced board members expect to face challenging situations, but they also expect full, transparent and timely communication with management as a fundamental element of fulfilling their roles.
Joining a board of directors is a significant responsibility, but it’s also an opportunity for experienced executives to use their skills to tackle new challenges, cultivate additional knowledge and expand their networks. When deciding whether to serve on a private or public company board, many directors see a distinct advantage in serving on the board of a private company, which is free of the rigidity that can constrain public boards, where mounting regulation and shareholder scrutiny have made it harder and more time consuming to serve.\(^1\)

The opportunities for independent board directors, those who are not part of the ownership or the fund backing the company, are many. Private company boards don’t have the same legal liabilities and risks that can come along with serving on a public company board. For example, when a company is privately held, its directors can be more involved in growing the business, rather than acting as a watchdog for shareholders. They also may have greater latitude to work more closely with the CEO and other members of the management team.

That doesn’t mean private board service is void of challenges. If it’s a closely held company, a director may have limited influence. The governing body may be of limited use if the CEO or chairman has assembled a board that’s afraid to challenge the C-suite’s perspective and decisions.

What’s your type?

Board composition, benefits and challenges can vary depending on how the company is funded, such as by venture capital (VC), private equity (PE), or family ownership. Different board skills may be needed in different phases of each of these types of businesses.

**Venture capital**

Like any private company, the board composition of a VC-funded entity depends on the company’s stage of growth. Early on, VC company boards are comprised primarily — often exclusively — of the owners: the venture capitalists and the founders. Because these companies frequently aim to go public, they often want directors with the insight associated with public company experience, whether that comes from serving on a public company board or as a senior executive with a public company.

As VC-backed companies expand, they also need board members who can objectively critique and advise the management team as it designs and executes strategy. These directors can provide perspective on what’s happening in the capital markets and in the company’s industry. As the company progresses directors with specific skills, such as expertise in corporate governance or audit committee service, are typically needed.

Directors who have served on the boards of successful VC-funded companies tend to be
Private company board service

highly sought after because they understand the dynamics of private company investment and have the ability to help other companies navigate the various stages of development and growth.

**Private equity**

Boards of PE-backed companies are tasked with ensuring these companies are ready for an IPO or an acquisition. One of the benefits of serving on this type of board is the level of business sophistication and operational maturity the PE funds infuse into private companies as they are positioned for exit. PE portfolio board composition typically consists of the lead investment professionals, who sponsored the deal, the CEO and may include other operating executives from the PE firms. Over time, the board may evolve to include a select group of independent directors.

One of the major differences between public and private boards is the stringent governance requirement that public boards must fulfill. But good governance and enterprise-wide risk management are growth drivers, and PE-backed boards are adept at using these elements to enhance performance. All of this means that independent directors with operational, industry and governance experience are highly prized by PE funds.

**Family-owned**

Because they are not subject to investors’ expectations, family businesses can be more nimble and focus on long-term strategy, instead of short-term share prices. However, many family-owned companies benchmark themselves against their public competitors, so they want directors armed with relevant experience and leading practices.

Directors of family-owned companies are expected to provide more than business intelligence. They serve as coach, counselor and peer advisor and they must consider how strategic and operational recommendations, such as succession planning and dividend policy, will affect family dynamics.

These boards typically include family members active in the business, key management executives as well as independent board members with varying degrees of experience depending on the skill gaps of the non-independent members. Independent directors may also include trusted advisors such as an accountant, attorney or consultant, or they may be respected business leaders or professionals in the community.

The director’s role may vary depending on the owner’s needs or expectations as well as the family dynamics. For example, one director may serve a technical role and provide industry or subject matter expertise on issues such as legal, finance, or compensation. Meanwhile another director may serve more as a referee in family conflict. Some family businesses look for an advisory board with no real authority while others need a strong governing board.
The opportunities for independent board directors, those who are not part of the ownership or the fund backing the company, are many.

Knowing and understanding the needs and capabilities of the business owners, as well as their limitations, will help a potential independent board member know how he or she can best contribute to the success of the organization through board participation.

Identifying opportunities

Seasoned executives seeking a board appointment should be proactive, making their desires known to peers, search firms or headhunters that cover a particular industry. Compensation is not something to overlook, given the time commitment. Finally, fit is crucial. Consider the company’s stage of growth, ownership structure, industry, growth plans, existing board composition and leadership.

Questions for private company directors or prospective directors to consider

- Where is the company in its life cycle: early stage, rapid growth or preparing for an exit? Is the company backed by venture capital, private equity or is it family-owned?
- What skills are needed on the board to help propel the organization to the next stage?
- What experiences or competencies are lacking on the board or in senior management? What could a new director add to the mix?
- Do board members have the right mix of experiences, including industry, governance and function?

When a company is privately held, its directors can be more involved in growing the business, rather than acting as a watchdog for shareholders.
Governance plans for family businesses

According to Family Enterprise USA, family-owned businesses generate 57% of US gross domestic product, employ 63% of the nation’s workforce and are the societal stabilizers in most communities.

For many family business owners, their businesses are their lives. They are fully and personally invested in its success and, like public company management or boards, they are concerned about regulation, compliance and taxes. Family business owners are also focused on personal wealth, succession planning and family dynamics.

One way to ease these concerns is by establishing a family business governance plan, that can set expectations and outline procedures to help maintain the business, enable ongoing success and support the financial well-being of the family.

Developing a governance plan

A family governance plan – or family constitution – is a framework that aligns the family interests with the business strategy. Often, the plan is based on the founder’s principles and expectations about the future of the business, family wealth or reputation. Developing such a plan formalizes governance procedures and allows the owner to demonstrate his or her concern about the future of the company, including possible risks.

Clearly documented procedures and non-binding, written operational agreements should be included in any governance plan, along with a detailed communication strategy that keeps the family informed about the business.

For some family businesses, conflict can disrupt progress and have a negative effect on the bottom line, so a family governance plan should clearly document a preferred approach for handling conflict resolution. The plan can also provide detailed guidance for managing internal processes and contingency plans in case of an emergency or crisis.

Planning for future generations

A significant concern for many family business owners is the transition of the business to the next generation. A governance plan should detail the succession intentions.

A founder might want to see that certain roles and responsibilities are always filled by a family member. However, a plan can outline specific requirements, experience or training for family members seeking to step into executive positions. Such criteria can help ensure that people have the required qualifications and aptitudes.

Some plans require members to work externally before joining the family business. The plan can also include restrictions on the way a family member can work in the business and set forth how his or her performance should be evaluated.
Remember that equal and fair are not the same when dealing with family matters. Companies must clearly define the participation of family members and consider the treatment of spouses, children and grandchildren. The plan should also contemplate possible divorce or prenuptial agreements.

Assets, such as boats, planes and vacation homes, require a clear explanation about their ownership and use. A family constitution protects the financial assets of the business by defining the voting processes for family members, designating how and when the family can access cash, and specifying the appointment and authority of senior executives. Expectations related to philanthropic giving in a manner consistent with family values can also be included.

The plan should set guidelines for income distribution and define who gets what, when and how. In addition, it must establish stringent governance on how shares can be sold, both inside and outside the family, if applicable. This approach will limit risk and make it possible to raise capital for the business or release cash for family members.

A well-developed governance plan is even more important during and after a generational transition. Failure to institute a governance plan can result in such problems as a lack of financial discipline, an inability to make important strategic decisions and family member conflicts.

Leading practices

To begin developing a plan, it is important to recognize the unique emotional component of the family business and the complexity that it adds to almost every situation.

As an owner, you may want to consult a spouse, trusted advisor or the board to assist in developing the governance plan, and keep the following in mind:

- Include your philosophy of how you foresee the plan working
- Design a family mission statement to set the direction for the business
- Develop the plan when family members are amicable
- Educate the next generation and instill responsibility; make sure that your children understand the business
- Develop a plan with flexibility that considers the addition of future generations to the business
- Review the plan every three to five years or when there is a life event, significant growth, divestiture or change in family dynamic
- Communicate with your family about your expectations early and regularly so there is the greatest transparency among family members

The benefits of a good governance plan are many. Governance fosters a culture of mutual trust, provides guidance for operating the business, sets the direction for managing financial assets to ensure future wealth, and sustains the success of the family business for future generations.
Spotlight on private company financial reporting

After adding financial reporting requirements aimed primarily at large public companies over the past several years, standard setters and regulators are focused on addressing the needs of private and smaller public companies and their stakeholders.

Several initiatives are underway at the Financial Accounting Standards Board (FASB) and the Securities and Exchange Commission (SEC) that could ease the burden on these companies. The Auditing Standards Board (ASB) and the American Institute of Certified Public Accountants (AICPA) also have projects focusing on private companies.

A new focus

The financial reporting landscape for all companies has changed significantly over the past decade on many fronts. The Sarbanes-Oxley Act of 2002 created the Public Company Accounting Oversight Board (PCAOB), which establishes auditing standards for public companies. These changes, along with continuing calls for more disclosures and convergence with international accounting and auditing standards, have contributed to more complex and burdensome financial reporting requirements for private companies.

To promote capital formation and reduce the burden, standard setters, regulators and lawmakers are now focusing on how these changes might have hurt private and other small companies. The result is a growing number of differences between how US GAAP applies to private and public companies. Auditing standards for private companies are also diverging from those applicable to audits of public entities.

While the FASB has had efforts under way to focus on the needs and concerns of private company stakeholders, the latest actions by the FAF and the FASB reaffirm a strong commitment to that constituency.

Private Company Council

In 2012, the FAF Board of Trustees established a Private Company Council (PCC) with two primary responsibilities. First, the PCC was asked to determine whether exceptions or modifications to existing US GAAP are necessary to address the needs of users of private company financial statements. Second, the PCC was asked to advise the FASB on private company considerations in standard setting.

The PCC is setting its agenda in consultation with the FASB and with input from stakeholders. All modifications or exceptions to US GAAP require FASB endorsement, and the PCC will seek public comment on its proposals, similar to the due process procedures followed.

FASB and FAF initiatives

Improving the standard-setting process for private companies has become an area of focus on several fronts for the Financial Accounting Foundation (FAF) and the FASB.
Whether you represent private or smaller public companies or both, change is on the horizon.
Spotlight on private company financial reporting

Improving the standard-setting process for private companies has become an area of focus.

by the FASB on other proposed changes to US GAAP. If endorsed by the FASB, the exceptions or modifications will become part of US GAAP.

Private company decision-making framework

The private company decision-making framework is intended to be a non-authoritative tool for making consistent decisions when evaluating whether a sufficient basis exists for differences in recognition and measurement, disclosures, presentation, effective dates and transition methods for financial accounting standards for private companies.

The framework describes six key differences in the financial reporting considerations of private and public companies and the implications of those differences. The differences include the following:

1. Types and number of financial statement users
2. Access to management
3. Investment strategies of equity investors
4. Ownership and capital structures
5. Accounting resources
6. Learning about new financial reporting guidance

For each area in which relief may be provided (recognition and measurement, disclosure, display, effective date and transition method), the framework includes specific questions that the PCC and the FASB would consider when evaluating whether information is relevant to the users of private company financial statements.

Simplifying accounting for private companies

Over the summer, the FASB issued four proposals from the PCC to allow private companies to apply alternatives under US GAAP for financial reporting related to the following:

- Intangible assets in a business combination
- Goodwill
- Certain hedges involving interest rate swaps
- Applying consolidation guidance to common control leasing arrangements

These proposals are intended to simplify the accounting for private companies while still providing users of their financial statements with the information they need.

Auditing

Private company auditors will see changes in the audit process as a result of the ASB’s Clarity Project. One purpose of the Clarity Project was to converge US GAAS with International Standards on Auditing while avoiding unnecessary differences between these standards and the auditing standards for public companies developed by the PCAOB. The
updated auditing standards were effective for calendar year-end 2012 audits.

While the primary goal of the Clarity Project was to make auditing standards easier to read, understand and apply, the project led to some additional documentation and performance requirements for audits. The changes that will be most apparent to private companies are changes to the auditor’s report, including additional discussion of management and auditor responsibilities, new headers and the re-characterization of “explanatory paragraphs” into either “emphasis-of-matter paragraphs” or “other matter paragraphs” depending on whether the issue is something that is discussed elsewhere in the financial statements.

**JOBS Act**

The Jumpstart Our Business Startups Act (JOBS Act), enacted in April 2012, gave private companies greater access to capital without triggering public reporting requirements. As required by the JOBS Act, the SEC adopted final rules this summer to allow general solicitation and advertising in certain offerings of restricted securities that are exempt from registration provided all purchasers are accredited investors.

The new Rule 506(c) of Regulation D will allow any company (whether public or private, established or start-up) to expand its pool of potential investors without SEC registration. Issuers relying on the Rule 506(c) exemption are permitted to advertise their offerings if they take reasonable steps to verify that the actual purchasers are accredited investors, as defined in SEC regulations.

To protect investors from fraud, the SEC also adopted a final rule that disqualifies issuers from using any exemption under Rule 506 of Regulation D if the offering involves certain felons and other bad actors. That rule was mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act).

**What’s next?**

Whether you represent private or smaller public companies or both, change is on the horizon. Companies and their boards should monitor these developments and evaluate the potential effects they may have on the company’s processes, controls, financial reporting, communication with stakeholders and alternatives for access to capital. Planning early allows companies the opportunity to prepare for any uncertainties that lie ahead.
Additional resources

**Effectiveness and accountability in the boardroom**

*Kellogg School of Management, Corporate Governance Program*

December 8–11, 2013

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If you have feedback or ideas for future topics, please contact Sara Brandfon at sara.brandfon@ey.com.