CPA CHARTERED PROFESSIONAL ACCOUNTANTS CANADA

Small Company Boards

QUESTIONS FOR POTENTIAL ADVISORS AND DIRECTORS

Douglas Enns, FCPA, FCA, C. DIR

DIRECTORS' BRIEFING SERIES

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Preface

The Corporate Oversight and Governance Board (COGB) of the Chartered Professional Accountants of Canada (CPA Canada) commissioned this publication to help potential advisors and directors understand the responsibilities that come with an appointment to a small company's board. CPA Canada is committed to improving corporate governance by identifying and developing guidance on emerging issues.

Even the smallest companies have elements of governance in place. They plan their affairs, monitor results, implement systems of accountability and control, and ensure steps are taken to comply with governing statutes and regulations. Often an advisory board is involved and advises the owners on these matters. Boards of many small companies are adopting more extensive governance practices in which fiduciary board practices are more common.

This publication offers guidance to those considering joining a small company's advisory or fiduciary board, highlighting what potential advisors and directors should understand about governance practices and the board's role. Owners and managers may also benefit from the information about how a board can help drive business success.

The publication concludes with case studies featuring real-life examples of how small companies have used and adapted corporate governance practices to suit their unique needs and goals, along with a summary list of questions for potential advisors and directors to consider.

The COGB thanks the author, Douglas Enns, and the representatives of the companies portrayed in the case studies for their thoughtful comments.

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Introduction

Effective corporate governance can add value to small companies.

Fundamentally, corporate governance may be seen as a system of checks and balances that help organizations plan effectively and develop appropriate accountabilities. Effective governance usually involves independent parties who help decide the company's direction, oversee its affairs and make decisions to help safeguard the owners' interests. With time and effort, effective corporate governance can sustain and build value and prepare companies for their next phase of development.

Governance in small companies—those with fewer than 500 employees—may differ markedly from that of large, well-established companies. It is important for prospective board members to understand the special factors that are involved when establishing governance in small companies and how these factors can influence decisions on whether or not to join a small company's board.

If you are considering a directorship or advisory board position, you have the opportunity for personal growth and a chance to make a meaningful difference. You will also have many questions. For example:

- Do small companies need better oversight/governance?
- Do the owners really need me to provide oversight or would they be better off simply hiring a consultant?
- How involved will I need to be?
- How will my role differ from that of directors of other organizations?

In efforts to improve governance, small companies usually appoint advisory boards. This type of board may only make those decisions agreed on by the owner, and the scope of decision-making authority among advisory boards can vary widely.

If there are several shareholders, however, the company may create a fiduciary board. Some important legal differences between the two types of boards are outlined in Chapter 2.

Whether you are asked to join an advisory or fiduciary board may be less important than how the organization will work with the board. The roles may be quite similar, particularly if the owners rely on the board for input to key decisions and ongoing oversight.

Acting as an advisor or director for a small company may mean not only providing good oversight but also building the system of corporate oversight from the ground up—a process that is highly rewarding but entails a lot of work. The world of small business can change quickly. A startup company may progress from struggling at its outset to profitability. Bank loans or private capital may be required to finance growth and eventually a sale or initial public offering (IPO) may be considered. It is not uncommon for a startup company to become publicly traded within five to ten years.

As the company develops, each transition point presents an opportunity to reinvent corporate governance practices. The company's capacity to benefit from the implementation of good governance systems is driven by the ability of its advisory board members or directors to make a positive contribution.

In order for advisors and directors to be effective, they need to:

- understand the small business and the environment in which it operates
- understand the role they are asked to play
- adapt governance practices to meet the needs of the business
- add value
- ensure there is a fit with the company

In the following chapters, we examine the importance of governance and board oversight for small companies. We also set out some key steps for those who are considering a board position: assessing the company and its governance principles and practices, finding out more about the board and the expectations of your role as a member, and determining how you would bring value.

You can find additional useful resources and web links in the section "Where to Find More Information" at the end of this document.

CHAPTER 1
Understanding Canada's Small Business Environment

There are millions of small companies in Canada. They are vital to Canada's economy and Industry Canada statistics indicate their importance will grow significantly over the next few years.[1] Small companies with relatively few employees can generate significant revenues and lucrative returns for early stage investors.

With ongoing globalization and reallocation of the world's wealth, small businesses face mounting challenges. Canada's small businesses can, and must, compete in a rapidly changing environment. Canada's rich resource base, educated workforce and sense of social justice provide a strong foundation to compete internationally. Small businesses across a broad range of sectors and on the leading edge of innovation contribute diversity to our economy and play an important role in maintaining Canada's competitive advantage.

Ongoing Change in Small Companies

According to Industry Canada,[2] over 100,000 businesses are started in Canada every year. Within five years, half of them will still be operating and some will seek additional investment to continue their expansion.

1 www.ic.gc.ca/eic/site/061.nsf/vwapj/KSBS-PSRPE_July-Juillet2012_eng.pdf/$FILE/KSBS-PSRPE_July-Juillet2012_eng.pdf.

2 Industry Canada www.ic.gc.ca/eic/site/061.nsf/eng/rd02473.html.

The introduction of crowd sourcing and angel venture funds has opened new financing avenues. Startup companies are, however, more often financed by friends or family. In their first few years, startups are rarely in a position to borrow from a bank or credit union. Once the business becomes stable, the picture brightens and more traditional financing becomes available if needed.

Companies change constantly as they grow and mature. Debt financing, expansion-seeking investment and potential acquisitions are important milestones in a company's life.

What Governance Principles Are Unique to Small Businesses?

In many cases, governance practices that work well in large companies and not-for-profit organizations are based on the premise the organization will remain relatively stable and has the capacity to meet benchmarks. For many small companies, this is not necessarily true. Governance practices need to be adjusted to their more dynamic circumstances in order to add value.

Limited resources can intensify the challenges for rapidly changing small businesses. The ongoing involvement of advisors or directors can help the company optimize its approach to dealing with complex challenges and changing conditions. Qualified directors and advisors who understand the company's circumstances are in the best position to help owners address fast-paced change.

Governance in Small Companies—Some Key Principles

- **Small companies are not miniature versions of large publicly traded companies.** Corporate governance practices must fit the company's specific requirements.
- **Rapidly growing companies must manage changing needs**. A startup company may need to acquire additional investors as it grows and an IPO may follow. Changes in ownership must be accompanied by changes to the corporate governance model. As a company grows, independent viewpoints are increasingly beneficial.
- **In small companies, governance must add value to survive.** A formal system of corporate governance and board oversight is optional for privately owned companies. Corporate governance practices must be seen to be adding value to the business.
- **All organizations need some level of governance.** A company cannot survive unless:
  - the owners and directors or advisors share an idea of where the organization is headed
  - there is an appropriate set of controls in place to make sure the company stays on track
  - someone is ultimately responsible for making important decisions

With a general understanding of the environment in which Canada's small businesses operate and their distinct governance needs, people who have been tapped to fill an advisor or director role can start investigating the company's specific governance needs and challenges, as described in the next chapter.

CHAPTER 2
Understanding the Company, Its Governance and Challenges

A first step in making a decision about joining a small company board is to conduct due diligence to learn more about the company, where it is in its lifecycle, the governance system currently in place, and what the owners expect from a director.

Directors and advisors with no previous board oversight experience face a sharp learning curve when they are appointed to a board. On the other hand, experienced directors or those steeped in large company governance practices may also struggle with the board of a newly launched company.

Once you have been asked to join a small company's board, you should complete an assessment of the company and its current and planned systems of governance. This involves gaining a solid understanding of the company's business model and strategy, learning about its risks, culture and values, and building familiarity with its owners, current board and management.

This careful assessment will help you make an informed decision. It may also give you a head start in helping improve the company's stewardship if you decide to take on the challenge.

What Are the Foundations of Good Governance for Small Companies?

Small company governance is founded on the company's organizational structure, policies, procedures, operating model and internal controls. These are the basic components of any business regardless of its legal structure. Effective corporate governance practices, however, go beyond complying with the legal requirements for running a company.

Companies can be structured as proprietorships, partnerships or corporations. In small, privately held companies with one or two shareholders, the owner(s) run the day-to-day business and may also act as the board.

Other small companies have a large number of shareholders, with elected boards of directors and sophisticated corporate governance and management structures. In these situations, it is important to review the Unanimous Shareholder Agreement to ensure ownership interests are clearly set out and decision authorities defined.

In all cases, ensuring an effective plan is in place and overseeing its execution are two principal activities involved in the governance process.[3] Having a group of qualified independent outsiders may help in making decisions, identifying new opportunities and avoiding pitfalls.

Effective governance practices may also ensure the interests of the company's owners are enhanced over the long term. Such practices provide tools and a roadmap to guide directors in their oversight of decisions and optimal use of the organization's assets.

Is the Company Governed by an Advisory Board or Fiduciary Board?

For better governance, small companies usually appoint advisory boards rather than fiduciary ones. If there are several shareholders, however, the company may create a fiduciary board. Although the two types of boards may fulfill similar functions, there are important legal differences that should be considered.

3 Report of the Committee on the Financial Aspects of Governance, Gee and Co. Ltd. (London UK, 1992) at Section 2.5.

Small business owners may initially have an advisory board that provides input on planning and running the business. Advisory board members, called “advisors,” support governance by steering the company’s direction and overseeing its affairs as agreed with the owners. Advisors’ authority to make decisions may be limited.

As the business grows and becomes more complex, the owners or shareholders may elect or appoint “independent directors” to act on their behalf. Independent directors do not serve in any managerial capacity. They take on fiduciary responsibilities and are referred to collectively as a board of directors.

A fiduciary board has specific responsibilities that are set out in the legislation under which the company was incorporated and its articles of incorporation. The *Canadian Business Corporations Act* (CBCA)[4] has specified duties for fiduciary boards. With a fiduciary board, only the owners can make some decisions, such as agreeing to wind up the company. Other decisions, such as appointing a CEO, declaring a dividend and making major policy decisions, may fall to the board of directors.

Advisory boards do not have the same requirements, but good practice dictates that those duties should be considered. Although directors can delegate certain authorities to the CEO, they may not abrogate their accountability to the shareholders.

What Is the Company’s Ownership Structure and How Does That Affect the Board’s Role and Approach?

The company’s ownership structure, as it evolves over time, will influence the board’s approach and level of involvement. As the company grows and matures, its capacity to support a board and respond to its recommendations may increase and more structured governance systems and supporting resources may be required. When defining a board’s role, the company’s ability to provide information and respond to board recommendations must be considered.

A company’s legal structure also influences the elements of its governance, as the table below shows.

4 Ibid

	Single Shareholder Company	Majority Shareholder Company	Multiple Shareholder Company	Corporation Created on Behalf of Citizens
Advisory or fiduciary board?	Advisory board	Board of directors		
Who selects the board members?	Appointed by owner(s)	Appointed by majority shareholder	Elected by shareholders	Appointed through government or public board nomination process
How is ownership structured?	Single shareholder owns or directly controls all voting shares	Limited number of shareholders owns majority of shares	Proportional ownership changes as shareholders are added and more capital is raised	Not-for-profit, non-share capital corporation
Governance, terms of reference and board role	Advisory board advises owner(s) but has no authority beyond what the owner provides	Board's authority stems from corporate legislation and shareholder agreement, which is ultimacte decision-making authority		Board's authority and role defined by legislation and oversight agreement with government
Independence	Advisors exercise independent judgment; primary role is to advise owner	CEO may be a board member; founding shareholders active in management may be directors but are not classified as independent directors; the controlling shareholder(s) may be among this group or independent investor(s)	CEO is often a board member but ideally the majority directors have no management role; share ownership is more widely dispersed	Directors are independent; the CEO and executive management are rarely appointed as directors

	Single Shareholder Company	Majority Shareholder Company	Multiple Shareholder Company	Corporation Created on Behalf of Citizens
Board committees	Typically none	Board often acts as a committee of the whole to fill roles of audit, governance, nominating and compensation committees	Board typically appoints audit, governance, nominating and compensation committees	Audit, governance, nominating and compensation committees are sub-committees of the board with specific terms of reference; other committees may be appointed
How are board members indemnified?	Fully indemnified	Insurance contracts		Indemnification and insurance contracts

What Are the Company's History and Objectives for the Near and Long Terms?

Establishing a system of governance must also take into account the company's level of development and its near- and long-term objectives.

Startup Stage

A startup company may require advisors with functional skills in human resource management, accounting and project management. Startups should also seek advisors who are comfortable dealing with rapid changes in direction and high levels of uncertainty. It may be the board's responsibility to monitor how the company is maturing and determine when to expand the executive team, plan for new financing, or take steps to protect the company's intellectual property.

Stable Stage

Companies that survive the startup phase may need to solidify and incorporate systems and procedures that support an ongoing business. They may also benefit from retaining the flexibility to aggressively pursue good opportunities. Advisors and board members must be capable of helping the owners balance competing demands for rigour and systematization while allowing them to

devote sufficient time and energy to pursuing new opportunities. A company's survival of the startup phase does not lessen the need to pursue new opportunities. It is up to the board to ensure that complacency does not set in.

At this stage, the board typically spends more time helping to assess strategies and strategic options and balance them against needs to earn reasonable rates of return and mitigate risk.

Capital Raising or Exit Stage

Companies seeking a sale or new sources of capital require advisors and directors who understand the intricacies of negotiating the terms and conditions needed to meet the company's objectives. To accommodate the needs of new investors or owners and optimize the interests of all shareholders, a more sophisticated understanding of the role of governance is needed. The board may need to acquire new skills such as familiarity with joint ventures, mergers and bulk asset sales and negotiating with venture partners.

Pre-IPO Stage

Planning for an initial public offering (IPO) may signal the need to recruit directors with an understanding of the listing process and executive or governance experience with publicly traded firms. Investors gain comfort when they are assured that the board and executive are capable of running a publicly traded company.

Taking time to consider the company's ownership structure, longevity and near- and long-term objectives will help determine governance requirements and the board's composition. This also helps board members appreciate what will be expected of them in their advisor or director role, which is discussed in the next chapter.

CHAPTER 3
Understanding Your Role as an Advisory or Fiduciary Board Member

Fiduciary boards take on the responsibility of hiring, compensating and, when necessary, replacing the CEO. Where the CEO is not the principal shareholder, advisory boards of companies may also play a role in selecting and evaluating the CEO, but only at the owner's request. Regardless of the arrangement, a clear mandate is required to differentiate the roles and accountabilities of the CEO and the advisors or directors.

The board must work as a team with the CEO to fulfill governance responsibilities. Beyond ensuring compliance with legislation, this includes broader responsibilities such as increasing shareholder value, building a sustainable organization, and meeting social responsibilities.

What Are the Key Governance Responsibilities of Small Company Advisors and Directors?

Regardless of the type of board or the company's maturity, the essential governance responsibilities of small company advisors and directors include:

- ensuring a disciplined approach to planning and direction setting
- assessing key decisions independently
- setting and maintaining an ethical tone
- defining and redefining roles and responsibilities as the company matures
- gaining reasonable assurance that corporate information is accurate
- providing input into strategy
- contributing to risk management

Each of these responsibilities is described in more detail below.

Ensuring a Disciplined Approach to Planning and Direction Setting

A disciplined approach to planning contributes to an effective strategy. It allows an organization to assess its opportunities and risks, and to compare its performance at different times and under changing conditions. Advisors or directors who understand the company's business and the conditions it faces can:

- help identify important issues
- ensure comprehensive planning and direction setting
- oversee risks and opportunities

Assessing Key Decisions Independently

There are times in the life of any company when key decisions must be made, including investing in new initiatives, seeking new investors, divesting or shifting strategic direction. When the stakes are high, perspective can be lost and objectivity diminished. Skilled, independent boards can make valuable contributions by assessing strategy, ensuring an adequate return on risk, testing assumptions behind major decisions and ensuring the company complies with applicable statutes and regulations.

Independence is an essential feature of a board's effective oversight. Some, if not all, members of the board should be independent of management. Subjecting key decisions to objective scrutiny improves the likelihood that issues will be identified, and not missed or ignored.

Although management may feel they have taken steps to avoid bias when making decisions, the pressure to produce can impair that objectivity. In these cases, thoughtful, independent oversight of management's decisions can prove indispensable.

It is sometimes argued that appointed advisory board members are neither independent nor accountable because they are unelected and bear no financial responsibility. Their reputations are, however, on the line. Advisors must understand the need for independence. They should feel free to express their views in a forthright manner. If elected board members do not remain independent, they fail the shareholders who elected them.

Setting and Maintaining an Ethical Tone

For many companies, an important objective is to live up to their ethical values. For these companies, clear values and practices and a commitment to deal fairly with all stakeholders are critical.

As a company grows, it becomes increasingly reliant on its reputation, for example, to promote sales, recruit staff or attract investment. In fact, its reputation could be its most important asset. As effective stewards, advisors and directors must ensure the ethical principles that will drive the company are spelled out and that performance is monitored against these principles.

Defining and Redefining Roles and Responsibilities as the Company Matures

When a small company is at a growth stage, owners need to develop an organizational structure in which roles, authorities and responsibilities are established and documented. Founders play multiple roles in startups and small companies. They keep things under control while operating under tight financial constraints. As the business grows and new demands arise, important functions may not be performed because the founders do not value the activity or simply do not have time.

The process of reorganizing to accommodate growth may lead to the appointment of an advisory board. It is essential that the advisory board has a clearly defined mandate setting out the decisions for which it will be responsible and the contributions that advisors are expected to make. Lack of clarity may create confusion or mistrust on the part of the owner.

For boards with more than five members, it is useful to have complex decisions evaluated by a smaller committee, which then makes recommendations to the board. For example:

- If independent auditors are to be retained, an audit committee comprised of independent board members is usually formed.
- Governance and nominating committees are established to manage governance standards, recruit new board members, or oversee a board evaluation process.
- Compensation committees are struck to oversee the development of compensation policies, and they may play a role in determining pay grades and incentive compensation.

Gaining Reasonable Assurance that Corporate Information Is Accurate and Useful for Decision Making

Evaluating the company's financial position, disclosure and transparency is another important job of the board. A company and its investors need reliable information on which to base decisions. Reliable information is the product of effective controls systems that help ensure the information is accurate and free from manipulation. A board can often discern developments that may be worth exploring by observing whether information appears consistent over time and meets expectations.

Evaluating financial performance in a small company raises the question—relative to what? Where available, measures such as peer or sector comparisons can be used to get a sense of how well the company is doing. Often comparative information on direct competitors may not be available, as private companies do not usually disclose their operating results. For startups, comparisons to other companies may be provide little insight.

Regardless of whether the company's results can be compared to competitors, assessing performance is an important board role. Other ways to assess performance include determining whether a startup is on track to meet key deliverables, evaluating return rates on existing and new initiatives, and stress testing liquidity forecasts.

Providing Input into Strategy

While it is the CEO's job to formulate the company's strategic plan, board members should actively provide their input before the strategic plan is developed. They can contribute to the strategy process by:

- discussing the strategy with the owner and making considered suggestions
- challenging assumptions constructively
- surfacing issues
- clarifying the types of initiatives that will be pursued versus those that will not

Directors and advisors must collectively have sufficient understanding of the business, its strengths and weaknesses, and the sector in which it operates to be able to advise on strategy and assess whether a strategy is likely to be effective.

Contributing to Risk Management

The board also has a role in the oversight of risk management. It is important to ensure the company is pursuing opportunities within its capacity to manage its risks. Companies that are too conservative in their risk-taking may find themselves losing ground to more aggressive competitors. Understanding the potential downside risks of new opportunities is equally important. Taking on more risk than can be managed will prove unsustainable. The key is to find the right balance, and input from independent board members can lend an objective perspective.

Risk represents uncertainty. A broad range of viewpoints regarding risk can be helpful. It is important, for example, to assess the likelihood of potential new initiatives succeeding, and whether their anticipated returns will adequately reward the owners for the risks being assumed.

The board can play a helpful role in the oversight of risk by:

- helping the company understand the level of risk it can manage
- ensuring the rate of return generated on new projects and initiatives is sufficient to compensate the owner for the risks being assumed
- testing assumptions and fully debating them
- ensuring projections have been adequately tested and verified
- recommending risk mitigation measures

What Is the Role of the Board Chair?

The chair's role is to lead the board, build its culture, facilitate effective board performance and ensure that its terms of reference are followed. The owner, the CEO or an independent party may fill the role of board chair. If the board chair is independent of the owner and management group, the chair must work closely with them to ensure that pertinent issues are brought forward for discussion.

It is important for the chair to encourage each member to contribute to the work of the board and provide opportunities for board members to challenge and understand proposals. The chair may also be required to deal with dysfunction on the board if relationships become strained.

The chair must ensure the board functions effectively, its meetings achieve their desired objectives and the board fulfills its mandate.

Your Commitment, Decisions and Workload

Finally, it is important to consider the level of commitment, the major decisions you may be asked to make and the nature of the workload you may be asked to assume. The table below summarizes these expectations for advisors and directors at different points in a small company's life cycle.

	Startup	Growing	Seeking Exit	Seeking Capital	Multiple Share-holders
Type of board	Advisory	Usually an advisory board	Advisory board or board of directors	Board of directors	Board of directors
Number of directors or advisors	3+	4-6	4-6	4-6	6+
Time required annually	60+ hours	60-100 hours	125+ hours	150+ hours	150+ hours
Director/ advisor compensation	Often voluntary	$15k +/- with additional compensa-tion for chairs	$15k +/- with additional compensa-tion for chairs	Cash retainer plus equity	$15k – $50k +/- with additional compensa-tion for chairs plus shares
Key areas of decision making	Survival-related decisions, strategy pivots, CEO coaching and direct involvement	Strategic direction, risk return, major initia-tives and information systems	Valuation and exit terms	Inves-tor terms and deal structuring	Gover-nance, transpar-ency, CEO selec-tion and compliance

CHAPTER 4
How Can You and the Board Add Value?

A corporate governance regime must add value to the company to be considered effective. One of the main reasons for the increased number of advisory boards in privately owned companies is the additional value they bring to the company.

Regardless of the size and sophistication of the organization, boards must add value to justify their existence. An owner will expect a governance regime to deliver value and will critically assess whether board members are making a difference. An advisor or director should consider ways to measure the value they bring to the company. It is also important to consider the skills needed to ensure the board continues to add value as the company evolves.

Eight Ways to Add and Demonstrate Value

The board's capacity to add value is driven primarily by the degree to which its skills and experience align with the needs of the organization as it grows and evolves. The board's combined skill set is an important determinant of its ability to contribute to the success of the company.

To be effective, the board members must have the appropriate skills, experience and ability to work well together. Owners must be convinced that the board's observations and recommendations make sense and are likely to make a meaningful difference.

To ensure you are adding value, directors and advisors should consider eight key points.

1. Understand Whose Interests Are Being Represented

Directors and advisors have a duty to act in the best interests of the company. To fulfill this duty they must consider the needs of a broad range of stakeholders. This can present a challenge when those needs are neither clear nor aligned. For example, board members need to speak up where dividends to the owners could impair liquidity, decisions could infringe on banking covenants, and share issuances could complicate future capital raises.

Advisory board members face an additional challenge in determining whether they are being asked to act in the best interests of the owner's company or the owner personally. If the sole beneficiary of the advisors is the owner, advisory board members may view their role as a consulting one. If they are being asked to help set the company's direction and oversee its affairs on behalf of a broader group of stakeholders, their role is governance.

This is more than mere hair-splitting. Unless the owners and advisors are aligned on the role the advisory board is being asked to play, they may work at cross-purposes.

2. Be Alert to Early Warning Signs

Board members must have a sufficient understanding of the challenges and opportunities facing the company to be able to give sound advice and make informed decisions.

Informed decisions anticipate the outcomes. The board's ability to anticipate indicatorzs of changes in the company or sector will add value to decision making.

3. Keep Pace

Startups and small companies change quickly. Rapid change can disrupt a company's plans without warning. Traditional approaches that involve extensive business planning to bring a new product to market may not apply.

Today's entrepreneurs are conditioned to lean development processes that conserve capital until products are proven in the marketplace. This may mean getting new products to the market before they have been fully developed and making iterative adjustments based on

customer feedback. It is a very different approach than having a product design based on extensive market research and perfecting development before the product is launched.

Changes in direction, or pivots, are expected and welcome in small companies. The decision to pivot can cause well-considered strategies to be cast aside. Because of the rate at which new information can disrupt entire industries, there is often value in getting products to customers as quickly as possible. Once acceptance has been confirmed, improvements can be made based on customer input.

4. Deal with Ambiguity

Board members may be asked to make crucially important decisions without complete information, despite management's best efforts to provide it. Directors and advisors must be able to make decisions under ambiguous conditions and with no clear course of action. Within uncertainty, however, significant opportunities may lie.

5. Be Courageous

Directors and advisors must assess relevant issues and be prepared to express their views in order to form an independent opinion. Although their positions may not be adopted, it is through forceful debate that important issues will surface and be duly considered.

6. Share the Owner's Commitment

Owners make a significant commitment to their businesses. They may have pledged personal assets, deferred spending and spent sleepless nights hoping important decisions are correct. Startup companies risk a high failure rate and have limited capacity to recover from an ill-timed decision or a couple of bad years in a row. It is important that the board is aware of and shares the owner's degree of commitment.

7. Align with the Company's Direction and Values

Board members may be seen as representatives of the company who are helpful in persuading bankers and investors to consider a funding request. Unless you understand and agree with the company's direction and values, you should not accept an appointment to its board.

8. Measure the Value You Are Adding

Finally, it is important that board members gain clarity on the owner's expectations regarding the value advisors or directors are expected to deliver. Agreement must also be reached on how value is to be measured.

Assessing whether governance has added value may come down to determining whether the company's financial value has increased sufficiently. Improved financial performance is often a good measure of whether good governance has resulted in positive outcomes. The board can also influence some equally important non-financial outcomes.

Examples of measurable financial and non-financial outcomes that may demonstrate the value added by a board are outlined below.

Measurable Financial Outcomes	
Earnings	• The level and nature of earnings companies achieve varies with the nature of the company, its objectives and external forces. • Companies should have a firm plan with specific milestones for becoming revenue producing and cash flow positive. At that stage, a plan should be in place to augment recurring, quality earnings. • Operating performance should compare favourably to peers, after factoring out non-recurring revenue and possible bubble effects, and taking into account the company's stage of development.
Liquidity	• The company should be able to raise debt and capital when required on favourable terms.
Assets	• The value of financial, physical, intellectual property and brand assets should be known and effectively managed to maintain and build their value. Informed decisions can then be made to continue to own the assets, divest at the appropriate time, or increase holdings through investment or accretive acquisitions.
Equity	• Equity is the value of committed investment and accumulated earnings after taxes and dividends have been paid. The company should have sufficient capital to be sustainable and leverage expansion and diversification where necessary.

Measurable Non-Financial Outcomes	
Key milestones	• For startups, meeting key milestones provides important signals that stability is being achieved and risk is being reduced. • For more mature companies, a track record of meeting objectives provides important signals to investors, suppliers and customers that the company can be relied on to meet expectations.

Measurable Non-Financial Outcomes	
Growth	• Growth is necessary on three critical fronts. Growth in the prospective and active customer base must be accompanied by growth in the capacities to support research, operations and production. These rely on the growth and maturation of leadership capabilities.
Innovation	• Innovation is essential to competitiveness. Competitors can easily gain advantage unless production processes, products and services are improved. • Innovation is increasingly important in making the case to bankers and investors that the company will continue to remain viable and eventually thrive.
Brand equity	• Successful companies are trusted and respected by investors, suppliers, customers and staff. • Trust and respect are earned by performing consistently and meeting self-imposed standards and ethical values.

CHAPTER 5
Small Company Boards in Action

The case studies in this chapter provide insight into an early phase startup company, a mature owner controlled company, companies that established an advisory or fiduciary board, and a privately owned company that has opted to establish a formal system of corporate governance.

As these case studies show, a company's need for formal governance practices increases as it grows in size, complexity and number of stakeholders. As the number of shareholders and other stakeholders rises, scrutiny of the board and its decisions increases, creating more complexity and accountability.

Each example underscores the importance of aligning a company's governance system and practices to support its strategic objectives, together with its capacity to support the governance process itself.

Case Study 1—Governance in a Startup

Governance of a startup organization must be approached differently from that of a mature, stable company or one seeking additional capital. Faced with limited resources and the need for the founders to focus on generating initial revenues to establish the company's viability, board members of startups should ensure their expectations surrounding governance take these realities into account.

Dataon Inc. started out as a website builder but found its database management skills could be better applied to building human resource information systems (HRIS). A decision was made to change the company's business model to focus on HRIS.

The investment group that financed Dataon was experienced in guiding companies through the startup phase where changes in direction are expected and, if handled properly, can add great value.

The investors understood the need for "light touch" governance when acting as a loosely structured advisory board. They tracked the company's plans and its financial progress, provided accounting and financial support, helped identify areas of risk, and provided valuable contacts. Their ongoing oversight helped the company identify and avoid potential pitfalls. By stressing the importance of early cash flow positivity, Dataon quickly moved from startup to become a stable operating company.

Today, the company is recognized as a leading supplier of HRIS tools, earns consistent profits and employs over 400 people.

Case Study 2—Sounding Board and Self-Imposed Discipline

As companies grow and mature, their operations become more complex, decision making becomes more refined and the need for reliability becomes more important. Although business owners may not wish to relinquish control of their business, many of them recognize the value in seeking input from qualified advisors, adding rigour to the company's reporting systems and testing important decisions. Owners may seek similar support when planning succession, deciding to diversify, or seeking financing.

Since its incorporation 15 years ago, Starfish Medical has become a leader in providing medical product development services for its clients.

For scientific research companies like Starfish, discipline at all levels is crucial because clients may base important investment decisions on the company's findings.

The founder remains its owner, principal shareholder and CEO. He sets firm standards for the company's development programs and imposes similar standards on his executive leadership. By assembling an advisory board, the owner has guaranteed that a review of the company's affairs is completed regularly.

The founder established an advisory board comprised of people with varied experience in areas such as technology startups, executive management and global engineering. The advisors meet semi-annually, and more frequently when needed. The owner prepares a full board reporting package, including updates on operations, emerging issues, strategic planning proposals, risk assessments, workforce commentary and financial reports. The advisors comment on the information and present recommendations on future actions.

This advisory board acts primarily as a sounding board and sanity checker. Functional expertise at the board level enables advisors to provide effective input into strategic planning, which is invaluable given the sophisticated nature of the business. The advisors understand the complex nature of the company's business and operations, and they strive to keep current, which adds value and saves time at board meetings.

By matching the skills and backgrounds of its advisory board members with their role within the company's business model, Starfish has ensured there is sufficient input and oversight to keep the company on track. The reporting package the advisors receive before each meeting helps them address critical issues and assess the company's current condition, emerging issues and prospects.

Case Study 3—Setting Up an Advisory Board to Enhance Long-Term Value

Some business owners believe that advisory boards can provide benefits beyond improving the company's operations to enhance the company's overall value and open new opportunities.

Monk Office is a well-established, locally owned office supply retailer. It has a reputation for quality, customers have remained loyal over the years, and the company has outlasted major competitors. The owner wants the company to have a long-term plan to increase its value.

The owner established an advisory board, among a variety of other means to strengthen the company's foundation for future growth. Experienced advisors were retained and comprehensive corporate governance practices adopted to help provide the discipline and accountability necessary to guide and oversee the strategic plan. The advisory board contributes to the development of the company's strategy, oversees its risk management, advises the owner on the appointment and remuneration of the CEO, helps define the company's values, and oversees the reporting systems.

The advisory board also helps broaden the options available to the owner. This may position the owner to receive a higher return commensurate with the time and effort expended, should he decide to sell Monk Office or take on new shareholders.

Case Study 4 — Establishing a Fiduciary Board

A company may mature to the point where its owners feel that accountability and oversight require more focus. To provide this focus, the owners may opt to implement a formal system of governance and establish a fiduciary board.

VMAC is an industry leader in vehicle-mounted air compressors with several patents to its credit. The company has operated successfully for 30 years. The controlling shareholders agreed in recent years to broaden the shareholder base.

A decision was made to establish a fiduciary board to guide the company as it moves forward. The board comprises members with expertise in engineering, accounting, governance and launching new ventures.

The board is chaired by an independent member. The board has developed terms of reference for itself and its committees that align with contemporary governance standards.

The roles of the board and CEO are differentiated, ensuring the CEO remains accountable without the board interfering in his ability to lead the company.

Case Study 5 — Gaining the Confidence of Shareholders, Regulators and Other Stakeholders

A formal system of governance may be required to help attract investment, satisfy regulators and investors that a system of proper checks and balances is in place, or prepare the company for an initial public offering.

Navigate Surgical develops advanced surgical navigation technologies which, for example, allow dental surgeons to monitor procedures in real time. Its products are licensed in Canada and Europe, and approval by the U.S. Food and Drug Administration is in progress. The company is at a “pre-revenue” stage and has completed its third round of financing. The board has played an important role at each stage of financing.

Medical technology is a high stakes business in which upfront investment can only yield returns after onerous technology trials and regulatory approvals have been achieved. The founding shareholders recognized at the startup phase that effective corporate governance was essential for demonstrating to regulators and investors that Navigate Surgical was vigilant in its technology development and business planning.

The three founders established a five-member board, adding seats to be filled by independent directors with expertise in technological development.

The new, independent board chair developed the board’s terms of reference. Responsibilities include:

- providing leadership and input for the company’s strategy setting, business planning, investment and budgeting
- overseeing major business and development proposals and risk management
- monitoring input from the company’s scientific advisory board
- acting as a nominating committee and identifying when the board’s skills must adapt and when to seek new directors.

An important element of the board’s role is reporting to shareholders. The board and CEO identify key milestones when setting the company’s strategy. As each milestone is achieved, more uncertainties are resolved and risk is reduced. These developments are reported to shareholders through regular update reports. A full briefing of shareholders and delivery of audited financial statements at the company’s Annual General Meeting ensures the board meets the balance of its reporting responsibilities.

The board’s role in setting operating and reporting standards and providing input into strategy and risk oversight has shaped development of the company’s business model and the manner in which it operates. This purposeful development has helped the company improve its reporting practices and compliance management.

Summary — Questions for Potential Advisors and Directors

As you can see from the preceding case studies, joining a board as an advisor or director provides an opportunity to make a meaningful difference. This is particularly true for small companies. It is important work because Canada's future prosperity depends on the success of companies being started today.

Small companies present unique governance challenges. Understanding their operating environment is essential to defining the role of the board and the issues that will need to be addressed to adapt that role as the company grows and its needs change.

One of the most important considerations to bear in mind when considering governance in small companies is that owners expect the investment needed to make governance work will add value.

The ability to meet the requirements of good governance, while at the same time ensuring the board adds value, is the most interesting and rewarding aspect of governance in small companies.

The following questions summarize issues that potential advisors or directors of small companies should consider to better understand governance principles and practices, the role of boards, and how boards can add value to small companies.

Understanding the Business and Its Governance

As discussed in Chapter 2, potential advisors or directors should complete an initial due diligence assessment of the company and its current and planned systems of governance, considering the following questions:

1. Is the company's business model sustainable?
2. Does the company's strategy make sense?
3. Am I comfortable with the kinds of risk this company takes?
4. Does the owner understand corporate governance well enough to make effective use of an advisory board?
5. Will I be comfortable working with the executive and my fellow board members?
6. Has the company developed codes of ethics and conduct?
7. Is the corporate culture a positive one?
8. Will any board members, including myself, have conflicts of interest? Am I satisfied that any such conflicts can be properly managed?
9. Am I comfortable that the company can comply with the requirements of its incorporation and the legislation under which it operates?
10. Does the owner understand my need to remain independent?
11. Am I prepared to accept that the owner may not always agree with my recommendations?
12. Will I be sufficiently indemnified? Does the company carry sufficient insurance?
13. Are there potential risks to my reputation?

Understanding Your Role as Advisor or Director

As discussed in Chapter 3, potential advisors or directors should find out about the role of the board they are being asked to join by asking the following questions:

14. Has the owner clearly explained the functions they wish the board to perform? Are the expectations reasonable?
15. Have corporate governance standards been documented? If an advisory board is being established, will the members be asked to help develop governance standards?
16. Are there terms of reference? Do the terms of reference adequately describe the role I will be asked to play and will I be comfortable in that role?
17. Is it likely I may be asked to assume a managerial or consulting role? Could this impede my effectiveness as an advisory board member?
18. Is the board's skill set equal to the task?
19. Do I bring the right skills and mindset to fulfill the role I have been asked to consider?

Adding Value

As discussed in Chapter 4, board members must ensure they clearly understand the value they are expected to deliver by considering the following questions:

20. Has the owner clearly explained what an advisory board is expected to do?
21. Do I feel this company is ready for and will benefit from a system of corporate governance?
22. Can I devote enough time to fulfill my responsibilities?
23. Do I sufficiently understand the company, its environment, circumstances and challenges?
24. Do I feel comfortable that I understand what can specifically add value to the company? How can I help ensure the company's success?
25. Am I confident my recommendations will be taken seriously and acted on? Can I still contribute if some of my recommendations are not acted on?
26. Does the company do a good job of identifying and pursuing opportunities? Do I feel the company generates a sufficient return on its initiatives? Can I help improve that return?
27. Is the company capable of identifying downside risk? Will I be able to contribute effectively to risk management?
28. Am I prepared to step aside if I feel I am no longer adding value?

Where to Find More Information

CPA Canada Publications on Governance
(available at **www.cpacanada.ca/governance**)

Director Series

Framework Series

- A Framework for Board Oversight of Enterprise Risk
- Overseeing Strategy: A Framework for Boards of Directors
- Overseeing Mergers and Acquisitions: A Framework for Boards of Directors

20 Questions Series

- 20 Questions Directors Should Ask about Internal Audit
- 20 Questions Directors Should Ask about Building and Sustaining a Board
- 20 Questions Directors Should Ask about Directors' and Officers' Indemnification and Insurance (2nd ed)
- 20 Questions Directors Should Ask about Special Committees (2nd ed)
- 20 Questions Directors Should Ask about IT (2nd ed)
- 20 Questions Directors Should Ask about Strategy (3rd ed)
- 20 Questions Directors Should Ask about Executive Compensation (2nd ed)
- 20 Questions Directors Should Ask about Insolvency
- 20 Questions Directors Should Ask about Governance Committees
- 20 Questions Directors Should Ask about Codes of Conduct (2nd ed)
- 20 Questions Directors Should Ask about the Role of the Human Resources and Compensation Committee
- 20 Questions Directors Should Ask about Responding to Allegations of Corporate Wrongdoing
- 20 Questions Directors Should Ask about CEO Succession

- 20 Questions Directors Should Ask about Crisis Management

Director Briefings

- Guidance for Directors: Disclosure and Certification — What's at Stake
- Guidance for Management: Disclosure and Certification — What's at Stake
- Board Oversight of Tax Risk — Questions for Directors to Ask
- Dhareholder Engagement — Questions for Directors to Ask
- Sustainability: Environmental and Social Issues Briefing — Questions for Directors to Ask
- Controlled Companies Briefing — Questions for Directors to Ask
- Diversity Briefing — Questions for Directors to Ask
- Long-term Performance Briefing — Questions for Directors to Ask

Board Bulletins

- Cybersecurity Risk — Questions for Directors to Ask
- Social Media — Questions for Directors to Ask

CFO Series

- Deciding to Go Public: What CFOs Need to Know

Additional References

- *The Canada Business Corporations Act* (CBCA), R.S.C., 1985, c. C-44 governs the incorporation of federally registered businesses in Canada: **http://laws-lois.justice.gc.ca/eng/acts/C-44/index.html**

- Provincial legislation governs provincially incorporated businesses. Provincial business corporations acts parallel the provisions of the CBCA.

- *Directors' Responsibilities in Canada* (2014), published for 25 years by Osler, Hoskin and Harcourt LLP, in collaboration with The Institute of Corporate Directors, provides an exhaustive overview of directors' responsibilities and effective board operation: **www.icd.ca/getmedia/581897ca-d69d-4d4f-a2a2-ca6b06ef223b/5467_Osler_Directors_Responsibilities_-Canada-FINAL.pdf.aspx**

- National Policy 58-201 *Corporate Governance Guidelines* sets out the board's responsibilities for companies that have issued securities: **www.osc.gov.on.ca/documents/en/Securities-Category5/rule_20050415_58-201_gov-practices_2.pdf**

- Strategic Catalysts Inc. has provided a comprehensive index of tools for boards of startup technology companies:
  http://earlystagetechboards.com/1-3-preamble#

  The company has also developed a complete board manual for startup companies:
  http://earlystagetechboards.com/wp-content/uploads/2013/01/Earlystagetechboards.com-complete-manual-Jan-2013.pdf

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Douglas Enns is the founder and CEO of Upturn Consulting Ltd.

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