

ORGANISATION

Governance issues in private companies

Proprietary companies are a form of company allowed under the *Corporations Act 2001 (Cth)* (the Act). Proprietary companies range from very small 'family' companies where only family members work in the company to very large companies employing thousands of people.

What is the nature of private companies?

A private company is a company that is registered as a proprietary company under the Act. Section 112 of the Act establishes two types of companies – proprietary companies and public companies. Section 45A of the Act states that a proprietary company must:

- have no more than 50 shareholders, although employee shareholders and shareholders connected with crowd sourced funding (CSF) offers do not count for this purpose; and
- not do anything to require disclosure to investors under Chapter 6D (except in limited circumstances).

This section of the Act also distinguishes between large and small proprietary companies. To be a small proprietary company after 1 July 2019, the company must satisfy at least two of the following requirements:

- the consolidated revenue for the financial year of the company and the entities it controls (if any) is less than \$50 million;
- the value of the consolidated gross assets at the end of the financial year of the company and the entities it controls (if any) is less than \$25 million;
- the company and the entities it controls (if any) have fewer than 100 employees at the end of the financial year.

A large propriety company is one which does not meet the tests to be a small private company. As a general rule only large proprietary companies are required to have their accounts audited and to lodge them with the Australian Securities and Investments Commission (ASIC). However, there are some situations, such as for companies controlled by foreign companies, where small private companies are also required to lodge audited accounts.

Section 201A of the Act specifies that a proprietary company only requires a minimum one director, provided that director is a resident of Australia.

Directors of proprietary companies generally have similar legal duties and responsibilities under the Act and at general law as directors of large ASX listed enterprises. One difference is that directors of proprietary companies can vote on a matter where they have a conflict of interest (section 194 of the Act) provided that this interest has been notified (section 191 of the Act).

Directors of a private company should be aware of section 111J of the Act and the small business guide in Part 1.5, which summarises the main rules in the Act that apply to proprietary companies.

Directors of proprietary companies should also be aware of sections 178A to 178C of the Act which requires the company to inform ASIC of any changes to its share structure or share register, at least for the top 20 shareholders.

Overall, legislated reporting and disclosure requirements for private companies are lower than those for public and listed companies but there is still a considerable regulatory burden surrounding the daily operations of a small business both under the Act as well as an array of other regulatory instruments relating to tax, occupational health and safety, employment practices, competition law, environmental law, privacy law (to mention but a few).

Commonly due to the small size, lack of complexity of operations and close family inter-relationship between shareholders, directors and senior executives, proprietary companies often have a quite informal approach to governance.

The needs of a company will change as it evolves and its operations move to new stages of development. A start-up company's needs are quite different to a mature company's needs. As a company grows and the scale and complexity of its operations increase, a more disciplined and structured governance framework will be required.

What is the difference of private companies?

Proprietary companies have distinct and important differences to both their public listed and not-for-profit counterparts. Their governance attributes need to be respectful of these differences if optimal performance within an effectively managed acceptable risk profile is to be achieved.

Some key differences include:

- Commonly they are under the absolute or effective control of the founder of the company, often the patriarch or matriarch of a family. That control may be effected at one or many multiple levels: that is, as controlling shareholder, as effective controller or primary influencer of board decisions, or as chief executive officer.
- The organisation's governance framework policies and practices are likely to be less formal and structured, with greater dependency on key people within the organisation (often family members) and their corporate memory and knowledge.
- The organisation's operations are likely to be undertaken under a much-reduced formal reporting and accountability framework both from a regulatory and from an operational perspective.
- Issues concerning key board member and executive succession planning and recruitment are often influenced more by family relations and loyalty than with merit-based principles.
- At times business principles and corporate focus may be subordinated to the personal and/or family interests of the dominant shareholder.
- Commonly, the smaller size and scale of operation of such organisations means that they are unable to economically justify employing highly skilled specialist executive personnel and may be more dependent on a more generalist management team augmented by external professional consultants and advisers.

Although the ASX Corporate Governance Council's *Corporate Governance Principles and Recommendations 4e (2019)* are only required to be followed by listed entities (on an *if not, why not* basis for the most part), nevertheless, they set out a number of generally accepted good governance practices and issues that can be very helpful to private companies and serve as a benchmark for good governance. The principles of good corporate governance remain equally as important for private companies; it is just the detail and its implementation which may vary to render it *fit for purpose* having regard to the circumstances and needs of the company.

The basic precepts of good governance are fundamental to all organisations: having clarity of roles and responsibilities, a focus on strategic objectives and prudential risk management, appropriate financial management, and disciplined accountability and transparency to members, shareholders and stakeholders.

A survey of the regulation of corporate governance in small to medium enterprises highlights a number of policy conclusions:¹

- The need for corporate governance guidelines to include flexibility, particularly for companies early in their life cycle;
- The need to reinforce the robustness of the *if not why not* approach and educate the market that disclosure, not uniformity, is important;
- The fact that corporate governance demands upon companies develop as they increase in scale and complexity with more diffuse shareholders;
- The fact that companies may carry with them problems of inadequate corporate governance and dysfunctional boards if these are not resolved early in the company life cycle;
- The existence of a critical period in corporate governance when private companies become listed entities with wider accountability and a corresponding need for a more independent board;
- The importance of legal and regulatory guidance and director education for companies preparing to list.

What special governance challenges do proprietary company boards face?

Owner-related issues

Owner/founder's time, attention and control can be stretched. Owners/founders often not only have to plan strategically but also operate the business with stretched resources (financial, human and other). They may struggle to find the time to view the business and market from a governance standpoint. They may lose opportunities due to a lack of time for strategic planning.

There can be a reluctance of the owner/founder to let go. As the company grows the owner may feel challenged when altering his or her role in the organisation by introducing independent directors or devolving executive responsibility to others. It can be hard to let go of the daily operations to become more strategic.

Succession planning is critical. Many small businesses suffer from key person risk: the success of the business is dependent on one person (that is, the owner/founder). If anything happened to that person, the organisation would change significantly and its viability may even suffer. All businesses need a plan for dealing with an unexpected loss of key people for whatever reason.

For an owner/founder who has trouble letting go, an advisory board is a good interim step before establishing a formal board of directors, as it is not legally constituted and has no decision-making power (unless specifically delegated). Further, the owner/founder is under no obligation to heed its advice. In the case of succession planning, an advisory board can be particularly useful in helping the owner/founder get an objective view on the potential successors and what they might require in terms of skills building and to help facilitate transition in ownership and/or management.

Limited resources

Proprietary companies commonly have only a small staff, often lacking in specialist skills and knowledge, and sometimes a limited cash flow.

While some may want to improve governance, this may come at a cost through extra administrative processes and time as well as the likelihood of extra personnel, which they may feel they cannot afford.

Growth and expansion

As a company grows, its needs change. There may be a greater need for strategic skills and knowledge than the existing management team can provide.

Small companies may be used to meeting basic compliance requirements (completing forms for ASIC, ATO etc.) but will need to become more strategic, including focus on risk management, to deal with greater requirements for disclosure, reporting and exposure to external scrutiny.

Risk management

Relationships within many private companies are based on trust with family, relations and close friends.

As the span of control extends beyond close relationships, extra administrative controls and assurance systems are warranted to manage business integrity risks.

There should also be business continuity plans in case of crises to ensure business sustainability.

1. T Clarke and A Klettner, 2010, "Governance Issues of SMEs", *Journal of Business Systems, Governance and Ethics*, Vol 4, No 4, https://www.researchgate.net/publication/266584236_Governance_Issues_for_SMEs, (accessed 23 September 2019).

When should a private company consider establishing a fully functional board of directors?

Many private companies will start, and continue for some time, with the one director required by law perhaps with the founder's spouse also notionally being a director. Good governance suggests the need for the addition of other directors and the formation of a more structured board is triggered by certain events, rather than merely being determined by size of the company (be that revenue or personnel based).

These circumstances or events can include when the company:

- Is making a transition from being family-owned to more professional management;
- Needs to more raise capital (debt or equity) including plans towards listing on the ASX to achieve this;
- Is experiencing rapid change in a dynamic industry and business setting;
- Is planning significant expansion and needs, extra skills and experience to guide it strategically;
- Is dealing with inter-generational succession issues.

Adding outsiders to the board of a small company, where key players have close and well-established relationships, can be challenging. However, the opportunities this can create can take a company forward to its next stage of development.

Independent directors appointed from outside the company can:

- Bring new skills and experience, and a fresh perspective and focus;
- Help identify emerging strategic issues and risks;
- Create more credibility in the market and give greater confidence of sound governance and management to investors and financiers;
- Assist the company in the development of its corporate governance and regulatory compliance;
- Act as a valuable sounding board for the CEO and management.

Of course, having independent directors on a board does not guarantee success. The key step is to identify the skills, experience and attributes that the company and its existing personnel need to meet its strategic objectives and needs. Potential candidates should be matched against these criteria. Even if family and friends may meet these criteria, they may still risk lacking objectivity and independence and therefore may not be the best choice.

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