



# SCALING UP

## THE IMPLEMENTATION OF CORPORATE GOVERNANCE IN PRE-IPO COMPANIES

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### INTRODUCTION

An effective system of corporate governance is considered critical to the proper oversight of companies. While companies are required to have a reliable corporate governance system in place at the time of IPO, relatively little is known about the process by which they implement it.

At its founding, a typical private company lacks many, if not all, of the features that will later be required by regulatory authorities. The board of directors is composed primarily of insiders—founders, investors, managers—and usually has no directors who meet the independence standards of the New York Stock Exchange and NASDAQ. Financial statements may be subject to an external audit but are usually not prepared in accordance with generally accepted accounting principles (GAAP). Financial reporting systems lack many of the controls necessary to comply with the Sarbanes-Oxley Act of 2002. Compensation contracts are dominated by equity awards and milestone-based payouts whose amounts are not justified in an annual proxy or explained in light of the company's compensation philosophy, pay objectives, or the peer-group analysis that public companies are required to disclose.<sup>1</sup> And yet, by the time companies go public, they have in place fully established (if not fully matured) systems of corporate governance.

How do pre-IPO companies go from essentially “no governance” at inception to meeting the rigorous standards mandated by the Securities and Exchange Commission (SEC) to protect the interests of public company investors and stakeholders?

### GOVERNANCE IN PRE-IPO COMPANIES

To understand the evolution of corporate governance in pre-IPO companies, we collected data from 47 companies that completed an Initial Public Offering in the U.S. between 2010 and 2018 (see Exhibit 1).<sup>2</sup> We found that pre-IPO governance systems are highly diverse in maturity, rigor, and structure; and that corporate leaders make vastly different choices about when and how to implement the standards required by the SEC in the time leading

up to IPO. These choices reflect the individual situations that each company faces in terms of industry, market opportunity, and growth profile, as well as the previous experience of management and investors, funding needs, and speed to IPO.

On average, the companies in our sample were nine years old at the time of IPO.<sup>3</sup> Major milestones include the following:

#### *5 years prior to IPO*

- The company hires the CEO (if different from the founder) who eventually takes the company public.

#### *4 years prior to IPO*

- The company implements the financial and accounting systems in place at the IPO.
- The company hires the external auditor used at IPO.

#### *3 years prior to IPO*

- The company first becomes serious about developing a corporate governance system.
- The company recruits its first independent (outside) board member.
- The company recruits the CFO who eventually takes the company public.

#### *2 years prior to IPO*

- The company hires an in-house general counsel.

Note that these numbers are *average* results (see Exhibit 2). The order in which these events occur varies widely across individual companies.

Companies that develop governance systems do so primarily as a part of a plan to go public. Eighty-three percent of companies say that they first became serious about developing a system of corporate governance as part of a plan to eventually complete an IPO. Having a corporate governance system is not necessarily seen as a required step in the evolution of a young, private company when the company intends to remain private.

Still, some aspects of corporate governance are embedded in

companies from their founding. For example, some companies voluntarily run formal board meetings even at a very young age, some recruit independent directors for their expertise before the company is required to do so, some maintain an independent compensation committee to separate management from the compensation setting process, and some maintain rigorous reporting and internal audit capabilities to assure lenders or customers of the quality of their statements. These practices are adopted for different reasons: a desire to satisfy investors, stakeholders, or regulators; to prepare for eventual scale; or because they are considered “the right thing to do” by the founder, CEO, or major investors.

In the minds of founders and CEOs, “good governance” is synonymous with having independent directors on the board. Companies typically recruit the first independent director to their board at the same time they become serious about developing a system of corporate governance. In interviews, when asked about key steps in developing a formal system of governance, founders and CEOs frequently referred to the decision to add outside experts to the board as the first step they took. Furthermore, the founders and CEOs we interviewed viewed the decision to recruit an independent director as very positive for the company, management, and the board. They cite the value of having people with outside experience to guide leadership as the company grows. According to one founder:

*In a privately held company, many times we're so involved in the day-to-day operations, it's hard to see the forest for the trees. [Independent directors] have more of an objective view. They see things that management doesn't see.<sup>4</sup>*

Another contrasts the experiences of working with independent directors and working with a venture-capital board:

*For VCs, the main questions always center on growth: If you obtain additional capital can you grow quicker? Independent directors tend to focus on whether the right controls are in place, governance factors, the potential risks, and whether we are properly addressing those as the company grows. ... One is more growth-based, and the other is more risk management-based.*

The independent directors that companies recruit have a diverse mix of skills—primarily industry, management, and commercial expertise, but also finance or banking experience, accounting or financial reporting experience, prior board service, or experience growing companies or taking them public (see Exhibit 3). The decision about what skills to look for when adding an independent director for the first time depend specifically on the company's situation—for example, whether the company is facing growth challenges, expanding into new markets, changing

product focus, or implementing more formalized reporting and control functions to support growth or in preparation for an IPO.<sup>5</sup> Independent directors are typically recruited through the personal networks of management and investors. In later stages of growth, private companies rely somewhat more on recruiters. Founders and CEOs are careful to ensure that newly added independent directors, regardless of source, have a positive impact on board culture and dynamics.

Seventy-seven percent of companies in our sample had a staggered board at the time of IPO. While staggered boards are considered by some governance experts to be indicative of poor governance quality, no founder or CEO who we talked to said that they received questions from potential investors about their decision to maintain a staggered board.<sup>6</sup> In the words of one CEO:

*A lot of companies have a staggered board when they go public. We had no push-back whatsoever. I think that's almost an expected part of the prospectus. ... I never got a question about it at all.*

Companies in our sample are fairly evenly divided between those whose founders take the company public (53 percent) and those that bring in a non-founder CEO (47percent – see Exhibit 4).<sup>7</sup> Of note, companies that recruit a non-founder CEO do not do so explicitly in order to take the company public but to scale the company or to solve managerial or commercial problems. One founder provides an example:

*The company was struggling when the CEO joined. We were in the midst of trying to implement a pivot in our strategy. ... We brought in a new CEO to help, somebody who believed in [our new] approach. He joined us in 2008, and really back then we were just trying to survive, and make this conversion, and we were able to do that. We really didn't start talking about paths to liquidity until 2013.*

Rigorous financial and control systems are put in place to support pre-IPO companies as they scale. The CFO who eventually takes the company public is not necessarily the executive who first implements these systems. In our sample, only two-thirds (65 percent) of CFOs who took the company public were tasked with overseeing the development of the financial and accounting systems in place at the time of IPO (see Exhibit 5). Still, interviews with founders and CEOs underscore the importance, time, and cost of developing these systems to the specifications required by the SEC.<sup>8</sup> Companies whose CFOs did not have deep prior experience running public-company reporting systems were required to bring in experts who have this experience—at the board level, CFO level, or accounting and controls level. In the words of one founder:

*We hired a head of internal audit, and he was really critical in getting our SOX controls in place and making sure that we had a sound control environment. ... We also hired a person for SEC reporting and technical accounting. We significantly increased the accounting team as part of the going public process because of the large increase in work.*

According to another:

*We already had gone through the discipline of preparing a clean audited financial statement. Transferring to what was required by the SEC was a big process, there's no question: There's more detail, more notes, and other documentation. But the disciplines were in place, and so it wasn't as difficult as it could have been.*

Some founders and CEOs note that provisions of the JOBS Act allowing an emerging growth company to file for IPO before implementing a control environment compliant with Section 404(b) of the Sarbanes-Oxley Act (as well as being allowed to file confidentially with the SEC) were critical in their decision to move forward with an IPO.<sup>9</sup>

Many pre-IPO companies transition from a regional auditor to a Big Four accounting firm as they prepare for IPO, but a sizable minority do not. Over three-quarters (77 percent) report using a Big Four auditor at the time of IPO. Companies who switch to a Big Four firm do so because they believe their company has become too large and complex for a regional firm.

An internal general counsel is considered the “least necessary” element of the governance system in pre-IPO companies. The typical company in our sample hires an internal general counsel two years before the IPO; however, a significant minority (18 percent) do not hire an internal general counsel until after the IPO, and 8 percent have no internal general counsel, even as a public company (see Exhibit 6). The decision to hire an internal general counsel is viewed through a cost-benefit lens. In the words of three different founders and CEOs:

*Our decision to hire a general counsel was not driven by regulatory requirements, just volume of work. The fees we were paying to outside counsel were extraordinary. There is an efficiency to having some of it controlled internally, and frankly just having more access to a legal perspective in-house. The person that we hired had been involved in a lot of SEC work in the past, so she had tremendous expertise in dealing with issues that are foreign to the rest of us.*

*The year after we went public, we decided to bring in an internal general counsel. [Three years later], we reevaluated that decision, and felt that because that individual was not an expert in everything, and they were using a ton of outsourced legal teams to get the work done, we were wasting a lot of money in our legal*

*G&A. We eliminated our internal legal team at the beginning of this year and replaced them with an outside law firm that could bring a higher level of expertise over all aspects of our business, including SEC, corporate board governance, contracting review, licensing, M&A, HR, etc.*

*Eventually we will hire an internal general counsel. Right now, it is hard to justify the numbers.*

Prior to IPO, companies rely on a variety of key performance metrics and milestone-based targets in awarding CEO bonus compensation. The most commonly used metrics include those relating to earnings and cash flow (53 percent), revenue growth (49 percent), innovation and new product development (44 percent), and business partnership and alliances (40 percent). Other metrics include those relating to employee hiring, retention, or satisfaction; regulatory or legal matters; product quality; customer growth and satisfaction, and sustainability. For the most part, these metrics do not change significantly as the company approaches IPO. Only 30 percent of companies add new performance metrics in the years immediately prior to IPO, and those that do add metrics add ones related to revenue growth, earnings or cash flow, and innovation or new product development (see Exhibit 7).

Interviews with founders and CEOs show that companies differ in the degree to which they believe compensation practices change following an IPO. Some take the viewpoint that pre- and post-IPO compensation practices are starkly different: the former reliant on milestone-based awards and stock option grants; the latter reliant on external advice, peer-group assessments, equity burn limits, and a formal disclosure process through the proxy. Others contend that the primary focus in awarding pay does not change: Both pre- and post-IPO pay outcomes depend primarily on achieving growth and performance targets that increase value to shareholders.

Founders and CEOs are generally satisfied with their governance systems. Ninety-one percent of companies are very or somewhat satisfied with the quality of corporate governance system they had in place at the time of IPO. They believe that implementing a governance system that meets the needs of regulators is costly, but recognize that it is a requirement of going public. (Interestingly, few founders and CEOs [12 percent] believe that the quality of their governance system has an impact on the pricing of the IPO, and those who do believe that it does estimate that it contributed 15 percent to the IPO price.)

Finally, they recognize that the systems they currently have in place are not final and will continue to evolve as the company matures in a public environment.

## WHY THIS MATTERS

1. There is no one-size-fits-all approach to governance in the pre-IPO world. Companies make vastly different choices on whether, when, or how to implement governance features that are common among public companies. What does this tell us about the relation between governance features and a company's specific situation? Should regulators and market participants allow public companies greater flexibility to tailor their governance systems to the needs of their business?
2. Corporate governance systems in pre-IPO companies are very different and much less developed than those of public companies. The founders and CEOs of pre-IPO companies recognize the value of having a quality governance system in place; at the same time, they recognize its cost. Which elements of governance add to business performance and governance quality? Which have made their way into the regulatory or market environment but do not meaningfully add to governance quality?
3. How much value does a good corporate governance system add to a company's overall valuation? Does good corporate governance impact the IPO price?
4. A typical startup company becomes serious about developing a corporate governance system only as part of a plan to eventually complete an IPO. What does this say about the value of corporate governance systems in small or medium sized private companies? When should a small or medium sized company that intends to remain private implement a governance system? Which elements should it include? Which are unnecessary or excessively costly, relative to the potential benefits? ■

<sup>1</sup> Compensation contracts in pre-IPO companies also offer potential windfall payouts at IPO that dwarfs the compensation amounts offered to the CEOs of many established, publicly traded companies.

<sup>2</sup> Surveys were mailed to the founders and CEOs (at the time of IPO) of 435 companies. Responses were received from 47 companies, representing a 10.8 percent response rate. Respondent companies come from a mix of industries including biotech and healthcare, technology, services, industrial, real estate, finance, and other. In-depth interviews were subsequently conducted with eight founders or CEOs. For a full summary of the data, see: Rock Center for Corporate Governance, "The Evolution of Corporate Governance: 2018 Study of Inception to IPO," (2018).

<sup>3</sup> Ritter calculates that during the period 2012-2017 the median age of companies at the time of IPO is 11 years. Averages are not available. See Jay R. Ritter, "Initial Public Offerings: Median Age of IPOs Through 2017," (June 2018), available at: <https://site.warrington.ufl.edu/ritter/>.

<sup>4</sup> Quotes are edited lightly for clarity. All quotes from Rock Center for Corporate Governance, "The Evolution of Corporate Governance: 2018 Study of Inception to IPO," (2018).

<sup>5</sup> This is consistent with Boone, Field, Karpoff, and Raheja (2007) who

study board evolution in the 10-year period following IPO and find that variations in board size and independence reflect "economic considerations—in particular, the specific nature of the firm's competitive environment and managerial team." See Audra L. Boone, Laura Casares Field, Jonathan M. Karpoff, and Charu G. Raheja, "The Determinants of Corporate Board Size and Composition: An Empirical Analysis," *Journal of Financial Economics* (2007).

<sup>6</sup> Daines and Klausner (2001) study the prevalence of anti-takeover protections (including staggered boards) in place at the time of IPO and find that they are used to protect management when a takeover is most likely and management performance most transparent. They find no evidence that staggered boards are used for entrenchment purposes. See Robert Daines and Michael Klausner, "Do IPO Charters Maximize Firm Value? Antitakeover Protection in IPOs," *Journal of Law, Economics & Organization* (2001). For a review of the research on staggered boards, see David F. Larcker and Brian Tayan, "Staggered Boards: Research Spotlight," *Stanford Quick Guide Series* (2015).

<sup>7</sup> This is somewhat consistent with Broughman and Fried (2018) who find that founder is no longer CEO in 60 percent of firms at IPO. That study also finds that the likelihood of a founder remaining CEO and maintaining voting control three years after IPO is only 0.4 percent. See Brian Broughman and Jesse M. Fried, "Do Founders Control Start-Up Firms that Go Public?" *European Corporate Governance Institute* (2018).

<sup>8</sup> Davila and Foster (2005) study the implementation of managerial accounting systems in startup companies and find that decisions on when and how to implement these are based on company-specific factors, including perceived benefits and costs, company scale, and management style. They also find that venture capital-backed companies are quicker to adopt formal accounting system components. See Antonio Davila and George Foster, "Management Accounting Systems Adoption Decisions: Evidence and Performance Implications from Early-Stage/Startup Companies," *The Accounting Review* (2005).

<sup>9</sup> This is consistent with Dambra, Field, and Gustafson (2015) who find that the JOBS Act led to a 25 percent increase in the number of IPOs in the year following enactment, with the increase in IPO activity occurring in companies with high proprietary disclosure costs. They also find that these firms took advantage of the act's de-risking provisions, allowing them to file the IPO confidentially while testing the market. Barth, Landsman, and Taylor (2017) find that companies that qualify as emerging growth companies under the JOBS Act offer more limited disclosure to investors, resulting in greater IPO underpricing and higher post-IPO volatility. See Michael Dambra, Laura Casares, and Matthew T. Gustafson, "The JOBS Act and IPO Volume: Evidence That Disclosure Costs Affect the IPO Decision," *Journal of Financial Economics* (2015); and Mary E. Barth, Wayne R. Landsman, and Daniel J. Taylor, "The JOBS Act and Information Uncertainty in IPO Firms," *The Accounting Review* (2017).

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*The Stanford Closer Look Series is dedicated to the memory of our colleague Nicholas Donatiello.*

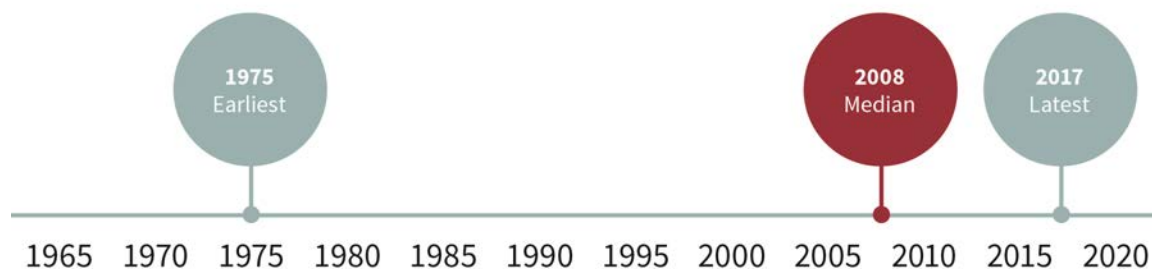
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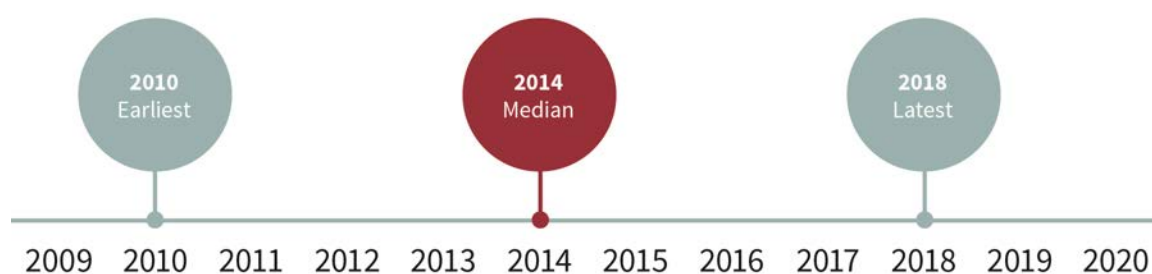


## EXHIBIT 1 — DESCRIPTIVE STATISTICS OF SAMPLE COMPANIES

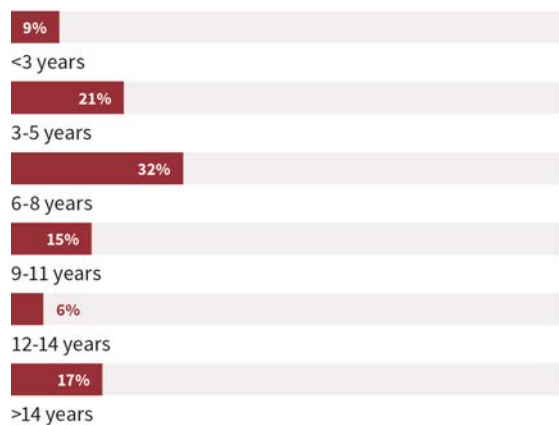
## Year of founding



## Year of IPO



## Years between founding and IPO



## Market value at IPO, \$ in millions



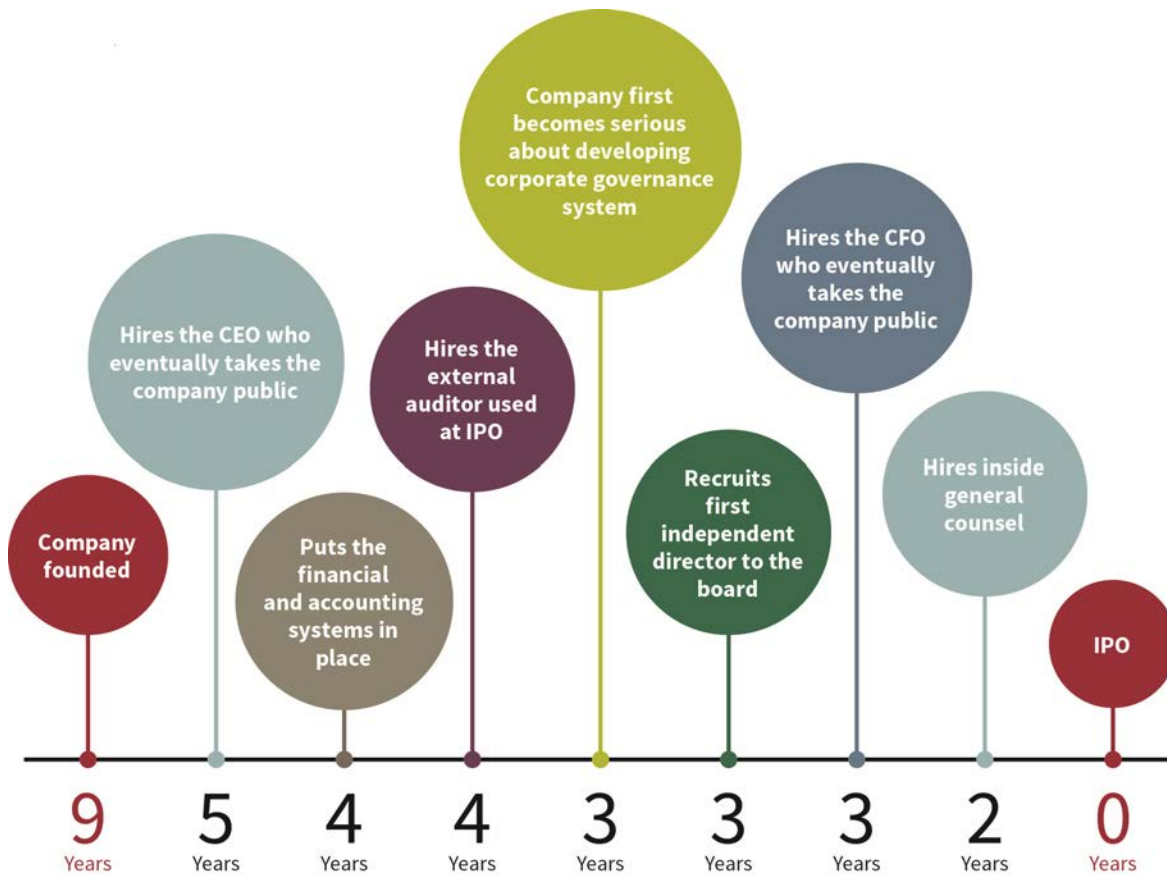
## Revenues in the year of IPO, \$ in millions



\* Five companies had no reported revenue in the year of IPO. These were biotech startups without commercial products.

Source: Rock Center for Corporate Governance at Stanford University, "The Evolution of Corporate Governance: 2018 Study of Inception to IPO," (2018)

## EXHIBIT 2 — CORPORATE GOVERNANCE MILESTONES: TIME RELATIVE TO IPO

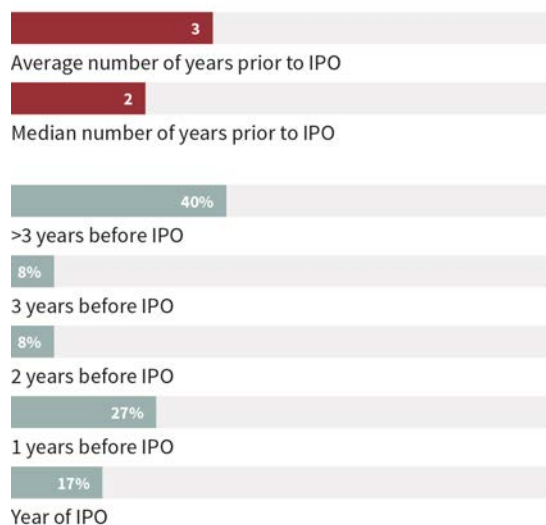


Source: Rock Center for Corporate Governance at Stanford University, "The Evolution of Corporate Governance: 2018 Study of Inception to IPO," (2018)

### EXHIBIT 3 — ATTRIBUTES OF FIRST INDEPENDENT DIRECTOR RECRUITED TO PRE-IPO COMPANIES

When did the company first add an independent (outside) director to the board?

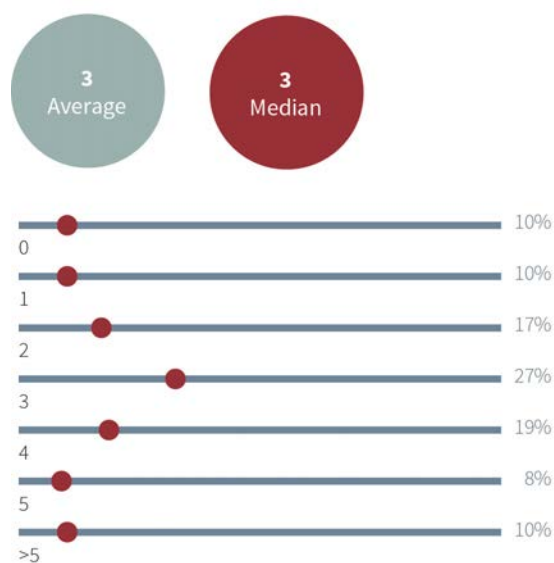
Relative to IPO



What were the primary skills of that individual that led the company to select him or her as its first independent (outside) director? (unprompted)



How many total independent (outside) directors did the company add to the board prior to IPO?



Source: Rock Center for Corporate Governance at Stanford University, "The Evolution of Corporate Governance: 2018 Study of Inception to IPO," (2018)

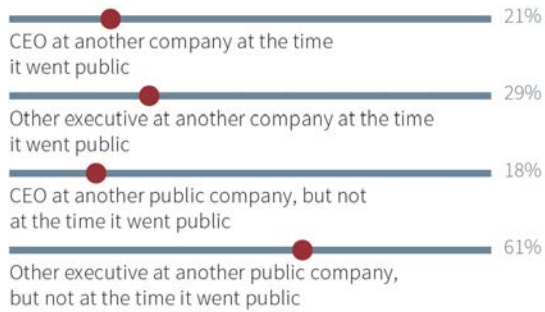


**EXHIBIT 4 — ATTRIBUTES OF CEOS IN PRE-IPO COMPANIES**

**Did the founder of the company serve as CEO at the time the company went public?**



**Did the CEO at the time of IPO have any of the following experience(s) prior to becoming CEO? (select all that apply).**



Source: Rock Center for Corporate Governance at Stanford University, “The Evolution of Corporate Governance: 2018 Study of Inception to IPO,” (2018)

## EXHIBIT 5 — ATTRIBUTES OF CFOS IN PRE-IPO COMPANIES

When did the company hire the CFO who took the company public?

Relative to IPO



Did this CFO oversee the development of the financial and accounting system in place at the time of IPO?

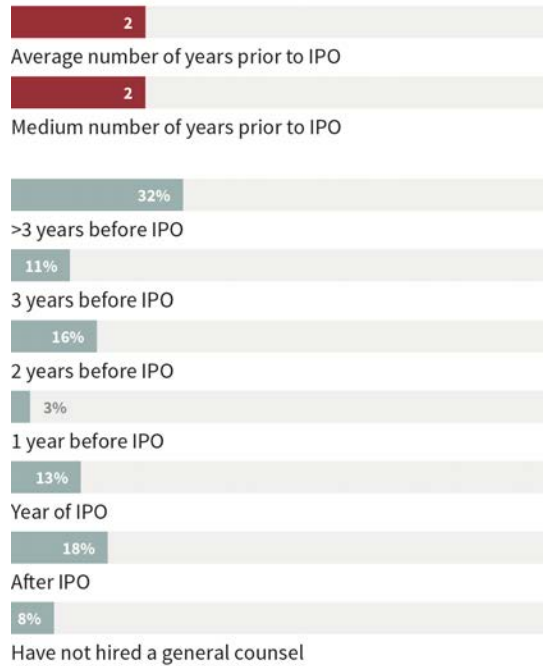


Source: Rock Center for Corporate Governance at Stanford University, “The Evolution of Corporate Governance: 2018 Study of Inception to IPO,” (2018)

## EXHIBIT 6 — DISTRIBUTION OF DECISION TO HIRE INTERNAL GENERAL COUNSEL IN PRE-IPO COMPANIES

### When did the company first hire an inside general counsel?

#### Relative to IPO



Source: Rock Center for Corporate Governance at Stanford University, “The Evolution of Corporate Governance: 2018 Study of Inception to IPO,” (2018)

## EXHIBIT 7 — PERFORMANCE METRICS IN CEO COMPENSATION CONTRACTS AT PRE-IPO COMPANIES

Which, if any, of the following performance metrics were included in the CEO compensation plan in the year prior to IPO? (select all that apply).



Which of these metrics were newly added in the years immediately prior to IPO? (select all that apply)



Source: Rock Center for Corporate Governance at Stanford University, "The Evolution of Corporate Governance: 2018 Study of Inception to IPO," (2018)