
THE EVOLUTION OF CORPORATE GOVERNANCE: 2018 STUDY OF INCEPTION TO IPO

ROCK CENTER **FOR** CORPORATE GOVERNANCE STANFORD

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EXECUTIVE SUMMARY AND KEY FINDINGS

PRE-IPO GOVERNANCE SYSTEMS ARE HIGHLY DIVERSE IN MATURITY, RIGOR, AND STRUCTURE THE SEC DICTATES PUBLIC STANDARDS, BUT PRE-IPO COMPANIES MAKE VASTLY DIFFERENT CHOICES ON WHEN AND HOW TO IMPLEMENT

“There is no obvious instruction manual for corporate governance in the pre-IPO world,” says Professor David F. Larcker, Stanford Graduate School of Business. “Pre-IPO companies are incredibly diverse in terms of industry, market opportunity, growth profile, and management experience, and the governance choices they make reflect this diversity. As companies approach IPO, we see them transition from the home-grown processes of the startup world to the standardized systems required by the Securities and Exchange Commission (SEC). Still, the choices they make and the timing of implementation are individually tailored to meet the specific needs of each company. The experience of management and investors, the competitive landscape, funding needs, and the speed to IPO all play a role in influencing how a company goes from essentially ‘no governance’ at inception to the rigorous standards required of publicly traded companies in the U.S.”

“There is no doubt that ‘good governance’ is required of private companies as they prepare for IPO,” adds Brian Tayan, researcher at Stanford Graduate School of Business. “However, the process for implementing good governance is not systematic, and certainly does not follow a predetermined path. Some companies recruit independent directors early; others do so at the last minute. Some have rigorous financial and reporting structures from the inception; others adopt them only as part of the plan to be SEC-compliant. Bottom line: CEOs and founders often figure it out on the fly—with considerable outside advice—while at the same time trying to keep their eye on the main goal of growing and managing the business.”

In summer and fall 2018, the Rock Center for Corporate Governance at Stanford University surveyed 53 founders and CEOs of 47 companies that completed an Initial Public Offering in the U.S. between 2010 and 2018 to understand how corporate governance practices evolve from startup through IPO.



KEY FINDINGS INCLUDE THE FOLLOWING:

GOVERNANCE SYSTEMS ARE PUT IN PLACE PRIMARILY AS PART OF A COMPANY'S PLAN TO GO PUBLIC

83 percent of companies say that they became serious about developing a corporate governance system as part of a plan to eventually go public. Over half of companies (58 percent) report that their leaders became serious about developing a governance system within 2 years of the IPO. This breaks down as follows: 29 percent became serious about developing a governance system more than 3 years before the IPO, 13 percent 3 years before the IPO, 19 percent 2 years before, 35 percent 1 year before, and 4 percent within the year of the IPO. On average, this occurred 6 years after founding.

Furthermore, the vast majority of the founders and CEOs of these companies (96 percent) believe that this was the correct time to take steps to implement more rigorous governance systems. Only 4 percent believe that they were too late, and none believe they were too early.

Interviews reveal that some companies were strict about implementing formal governance and control processes early on in the founding of the company. Examples include formally run board of directors meetings with minutes and subcommittees, the voluntary recruitment of independent directors to provide outside advice to management, rigorous accounting systems and financial reporting controls, and formal compensation setting committees composed of outside directors.

INDEPENDENT DIRECTORS ARE CRITICAL TO GOOD CORPORATE GOVERNANCE

On average, companies add their first independent director to the board 3 years prior to IPO. This occurs around the same time the company first becomes serious about developing a corporate governance system. 40 percent of companies add their first independent director more than 3 years prior to IPO, 8 percent 3 years prior to IPO, 8 percent 2 years, 27 percent 1 year, and 17 percent during the year of IPO. On average, the first independent director is added 6 years after founding.

The founders and CEOs of these companies look for a broad set of skills in the first independent director they recruit to the board: Industry experience (55 percent) and managerial or commercial background (31 percent) are the most frequently cited attributes. Others include finance or banking experience (24 percent); accounting or financial reporting experience (22 percent); prior board, governance, or regulatory expertise (18 percent); experience growing companies or taking them public (8 percent); and a broad mix of other skills and attributes, such as legal knowledge, personal fit, and integrity (10 percent).

On average, companies add 3 independent directors prior to IPO. This number varies widely across companies: 10 percent add more than 5 independent directors, 8 percent 5 independent directors, 19 percent 4, 27 percent 3, 17 percent 2, 10 percent 1, and 10 percent do not add any independent directors prior to IPO.



It is rare that companies add non-investor stakeholder representatives to the board. Thirteen percent report having a strategic partner on the board prior to IPO, 6 percent have creditors, 4 percent customers, 4 percent law firms, and 2 percent suppliers.

Interviews with the founders and CEOs of these companies indicate that they highly value the expertise that outside directors provide. They believe these directors bring a new perspective and more formal oversight to the company, and in general they view their contribution to board processes and governance as highly positive. Interviews suggest that founders and CEOs believe that adding independent directors is synonymous with the concept of good corporate governance.

OUTSIDE CEOs ARE BROUGHT IN TO SCALE A COMPANY, NOT NECESSARILY TAKE IT PUBLIC

Companies are fairly evenly divided between those whose founders take the company public (53 percent) and those that bring in a non-founder CEO (47 percent). Companies who bring in non-founder CEOs do so 5 years prior to IPO, on average. Over half (56 percent) hire this CEO within 3 years of the company's founding.

The vast majority of companies that bring in a CEO (73 percent) state that the CEO was not hired with the express purpose of a leading an IPO, while a quarter (27 percent) say that the CEO was hired for this purpose.

Outside CEOs have a broad mix of prior experience. Twenty-one percent have prior CEO experience taking a company public, while 18 percent have served as CEO of a public company but not at the time of its IPO (they were hired following the IPO in their prior company). Twenty-nine percent have prior experience working as an executive (below the CEO level) of a company while it went through the IPO process, and 61 percent have prior executive (below the CEO level) of a public company but not at the time of its IPO.

CFOS ARE MORE LIKELY THAN CEOs TO BE BROUGHT ON AS PART OF THE IPO PROCESS

The CFO who takes a company public is hired 3 years prior to IPO, on average. This breaks down as follows: 28 percent hire the CFO more than 3 years prior to IPO, 13 percent 3 years, 13 percent 2 years, 38 percent 1 year, and 8 percent during the year of IPO.

Over half (58 percent) of these CFOs have prior experience as the CFO of a public company, and 25 percent have other executive experience (non-CFO) at a public company. A significant minority (39 percent) have accounting firm backgrounds: 28 percent at a Big Four firm and 11 percent at another accounting firm.

Two-thirds (65 percent) were tasked with overseeing the development of the financial and accounting systems that were in place at the time of IPO.

Interviews with founders and CEOs underscore the importance, time requirement, and cost of developing a rigorous financial reporting system and control environment that meets the standards of the Securities and Exchange Commission. Those whose CFO did not have deep prior experience running the public-company reporting systems decided to bring in a controller, auditor, accounting executive, or board member to provide this expertise.

Many companies transition from a regional auditor to a Big Four accounting firm as they prepare for an IPO, although a significant minority do not. Over three-quarters of companies report using a Big Four auditor at the time of their IPO. On average, the auditor used at IPO was hired 4 years prior to IPO, although the time of hire varies widely: 47 percent hire the external auditor more than 3 years prior to IPO, 8 percent 3 years before IPO, 8 percent 2 years, 35 percent 1 year, and 2 percent during the year of IPO. Interview information suggests that companies that switch to a Big Four auditor do so because they believe their company has become too large and complex for a regional firm; the transition to a Big Four firm allows them to scale their business. This view, however, is not universal.

AN INTERNAL GENERAL COUNSEL IS THE “LEAST NECESSARY” GOVERNANCE FEATURE

An internal general counsel is not considered a required position within the company prior to IPO. A typical company hires an internal general counsel 2 years before the IPO. That said, 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 when public.

Interviews with founders and CEOs show considerable satisfaction with the external counsel they employ prior to IPO. Companies rely on external counsel for commercial contracts, patent development, employment matters, regulatory matters, and other purposes, including the preparation of IPO filings. They generally view a decision to hire an internal general counsel as a cost-benefit trade-off in comparison to working with external counsel. Some cite the advantages of in-house expertise; others cite the need to retain external counsel even after an internal hire is made, given the diversity and complexity of matters facing the company.

COMPENSATION DOES NOT CHANGE AS COMPANIES APPROACH IPO, BUT IT BECOMES MORE FORMALIZED AFTER IPO

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 partnerships or strategic alliances (40 percent). Other metrics used include those relating to employee hiring or retention (31 percent), regulatory or legal matters (29 percent), product quality (13 percent), customer growth (9 percent), employee satisfaction (9 percent), environmental sustainability (9 percent), and customer satisfaction (4 percent).

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 primarily add metrics related to revenue growth (11 percent), earnings or cash flow (11 percent), and innovation or new product development (11 percent). Seventy percent of companies make no changes to their performance metrics as they prepare for IPO.

Founders and CEOs have varying opinions about the degree to which they believe compensation practices change after completing 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 decisions to grant variable-based pay depend primarily on achieving growth and performance targets that increase value to shareholders.

GOOD GOVERNANCE IS REQUIRED; ITS DEFINITION AND VALUE ARE UNCLEAR

Founders and CEOs are generally satisfied with the quality of the corporate governance system they have in place at the time of IPO. Eighty-nine percent say they are either very satisfied or satisfied with the quality of their governance system at IPO.

Most founders and CEOs do not believe that the quality of their governance system has a material impact on IPO pricing. Only 12 percent believe the quality of their governance impacts IPO pricing, and they estimate that it positively contributes 15 percent to price. However, in interviews, most founders and CEOs express the view that having a high-quality governance system is not optional but required by institutional investors and the Securities and Exchange Commission, and therefore it is difficult to estimate its impact on pricing; not having a governance system in place would prevent their company from going public.

Few companies in our sample have dual-class shares at the time of their IPO—4 percent. However, more than three-quarters of companies (77 percent) have a classified or structured board at IPO. Founders and CEOs value the continuity and stability that a staggered board brings to their company. Interestingly, institutional investors are tolerant of staggered boards at the time of IPO, even though some governance experts consider staggered boards to be indicative of poor governance quality.¹

¹ See David F. Larcker and Brian Tayan, “Staggered Boards: Research Spotlight,” Stanford Quick Guide Series (September 2015), available at: <https://www.gsb.stanford.edu/faculty-research/publications/staggered-boards>.



Methodology

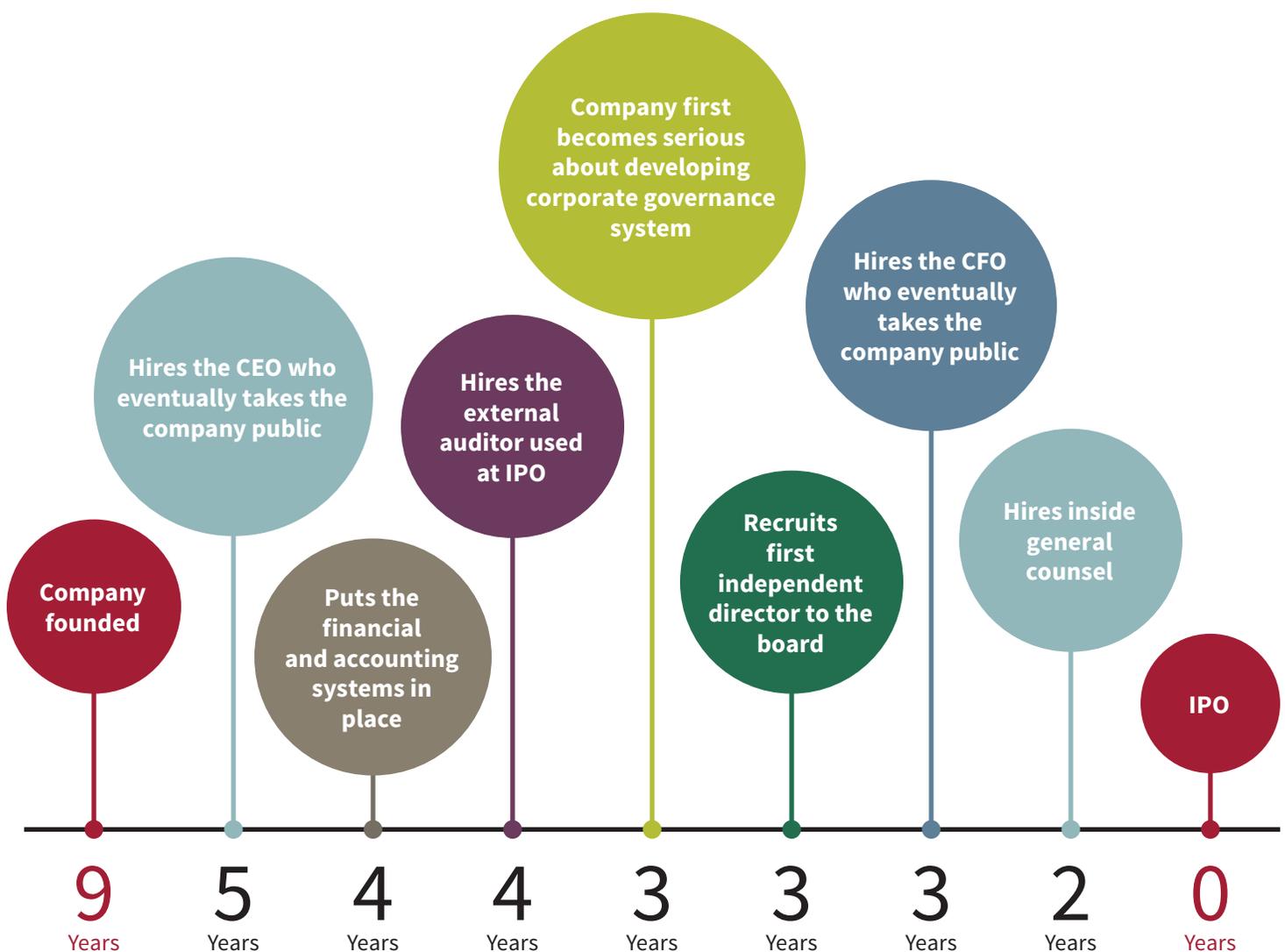
In summer and fall 2018, the Rock Center for Corporate Governance at Stanford University surveyed 53 founders and CEOs of 47 companies that completed an Initial Public Offering in the U.S. between 2010 and 2018 to understand how corporate governance practices evolve from startup

through IPO. Respondent companies reflect a diverse group of industries including biotech and healthcare, technology, services, industrial, real estate, finance, and others. In fall 2018, we conducted interviews with founders and CEOs of 8 companies.



The Evolution of Corporate Governance: 2018 Study of Inception to IPO

Corporate Governance Milestones: Timeline Relative to IPO (Averages)



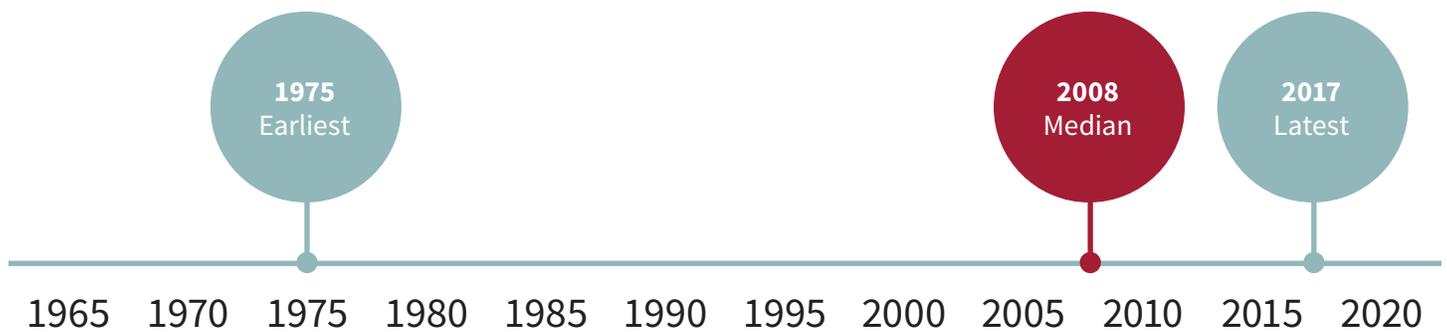


The Sample: Descriptive Statistics

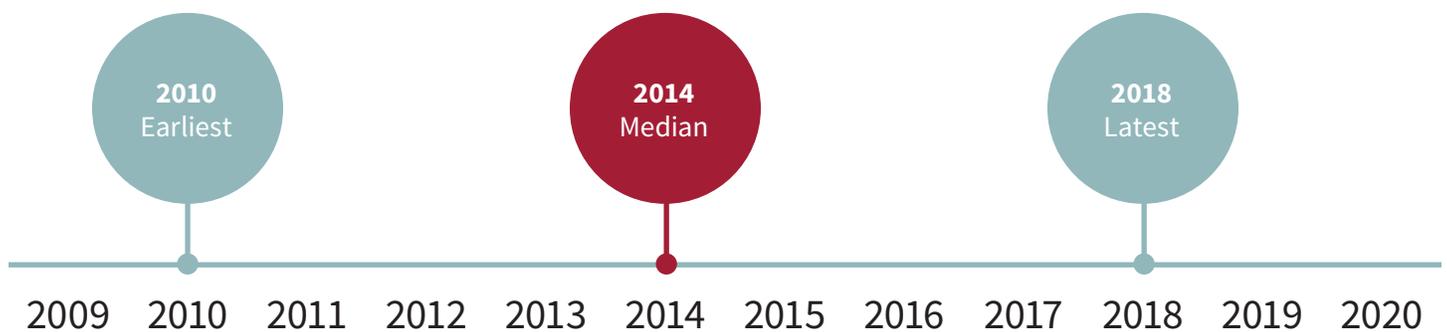
1. Number of companies in sample



2. Year of founding

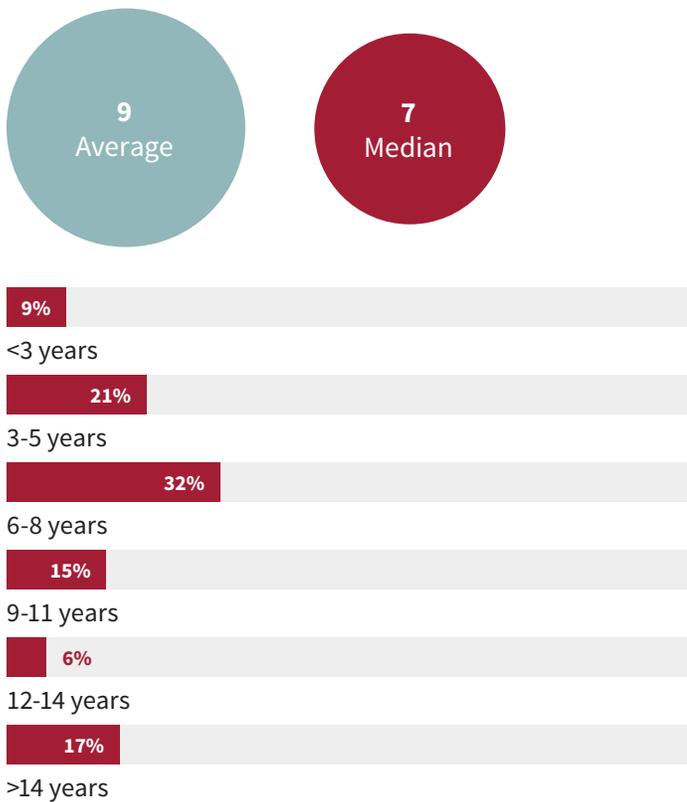


3. Year of IPO

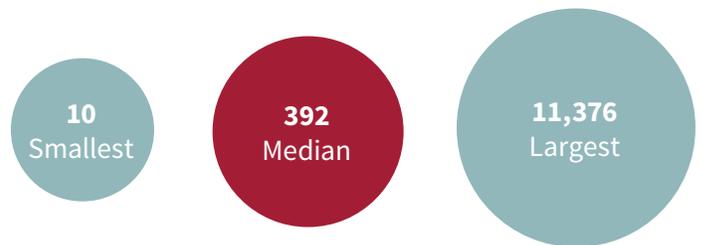




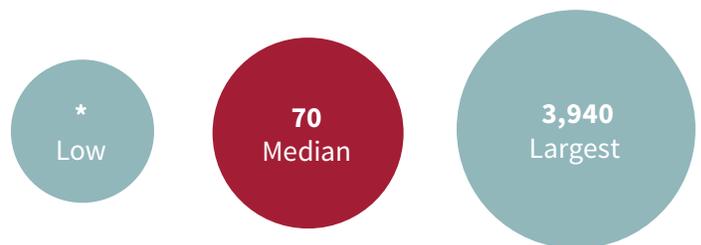
4. Years between founding and IPO



5. Market value at IPO, \$ in millions



6. Revenues in the year of IPO, \$ in millions

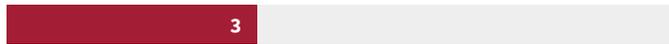


* Five companies had no reported revenue in the year of IPO. These were biotech startups without commercial products.

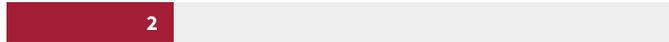
Survey Results

1. When did the leaders of the company first become serious about developing a corporate governance system (for example, a more independent board of directors, rigorous financial system, etc.)?

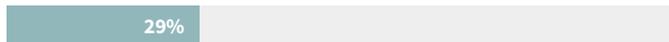
Relative to IPO



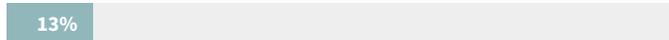
Average number of years prior to IPO



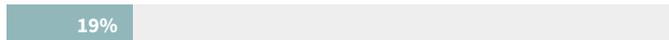
Median number of years prior to IPO



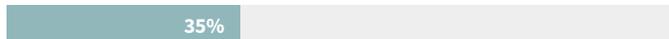
>3 years before IPO



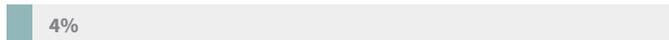
3 years before IPO



2 years before IPO



1 years before IPO



Year of IPO

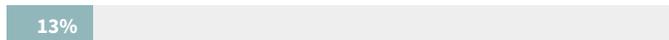
Relative to Founding



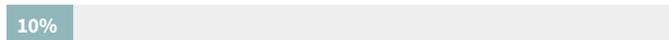
Average number of years after founding



Median number of years after founding



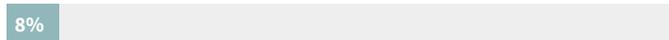
Same year as founding



1 year after founding



2 years after founding



3 years after founding

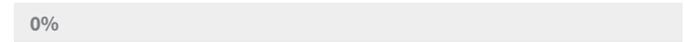


>3 years after founding

2. In retrospect, was this the correct time to become serious about developing a corporate governance system?



Yes



No, too early



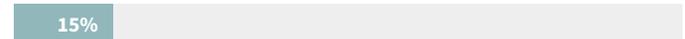
No, too late*

*Those who said “no, too late” became serious about developing a corporate governance system only 1 year prior to IPO, on average

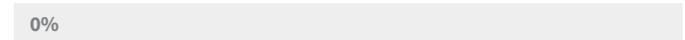
3. What was the ownership structure of the company at the time it became serious about developing a corporate governance system?



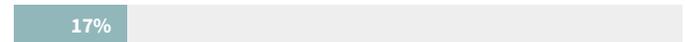
Private, majority-owned by venture capital



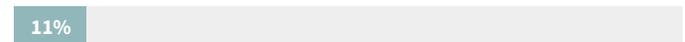
Private, majority-owned by private equity



Private, majority-owned by another company



Private, majority-owned by individual investors



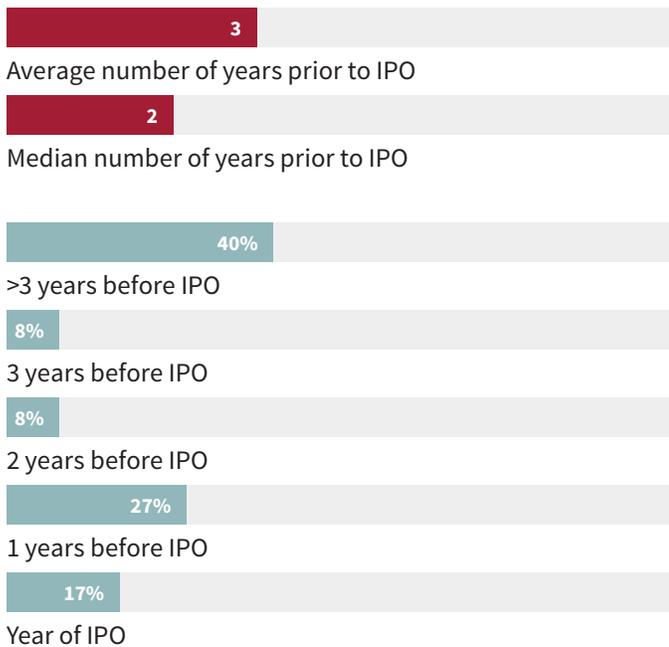
Other

4. Did the company become serious about developing a corporate governance system as part of a plan to eventually complete an IPO?

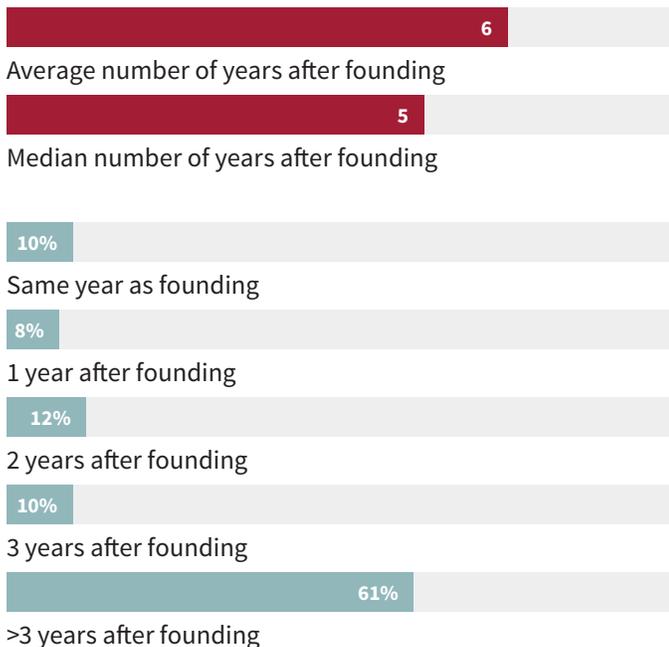


5. When did the company first add an independent (outside) director to the board?

Relative to IPO



Relative to Founding



“[Adding VCs to the board] changed everything dramatically. They became the dominant board members. ... They called the shots, no question. They were very complimentary and deferential to management, but the ultimate decisions were theirs.”*

“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.”

“We knew we needed to bring in people who had more governance experience. So about six months before the IPO, about half of the VCs stepped off and were replaced with true, seasoned, public company board members. After the IPO, we phased out the rest of the VCs.”

“[The independent directors we added] were all C-Level executives of public companies. So just the process of going public, the pricing committee, meeting investors and thinking about who really should be your targets: they were invaluable in that sense. ... They helped us manage and avoid pitfalls.”

“We have directors with strong functional expertise and operating roles [at other companies]. ... It is a very collegial board, encourages management, fact-based, diligent in terms of making sure that management does their job. It is a much better relationship working with a public board than working with the private, VC-dominated board.”

“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.”

“The board is suitably knowledgeable and experienced to get into the details of each element of the business. They all have international experience, knowledge of the industry, and several are technically deep. ... The advice they give is based on tremendous experience. It’s very valuable.”

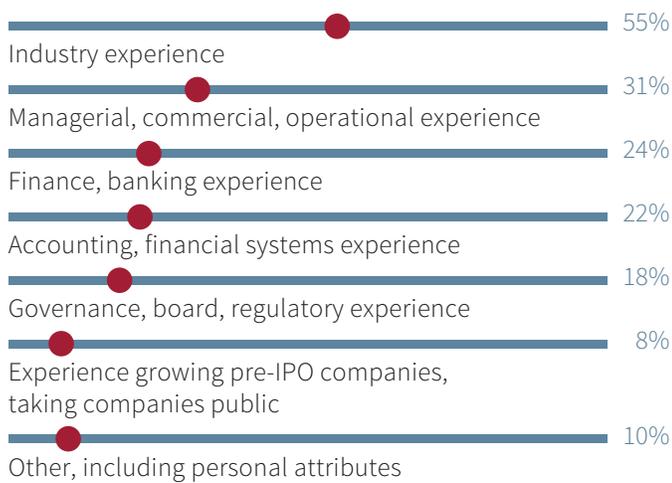
“We looked for a human resources expert because we wanted somebody who could help us with the cultural change of becoming a public company. “

“Of the four independent directors we added, two came through recruiters and the other two I recruited—one I knew personally and one was someone I had met multiple times in the industry.”

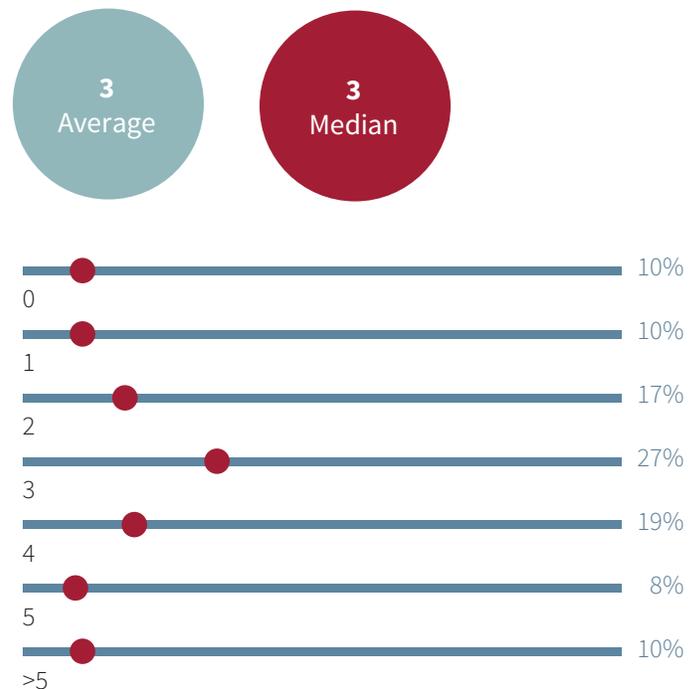
* Comments edited lightly for clarity.



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



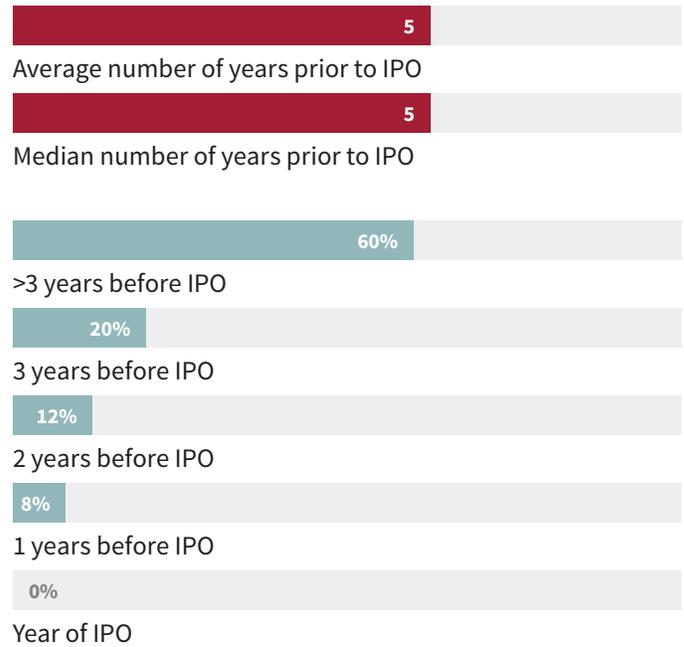
7. How many total independent (outside) directors did the company add to the board prior to IPO?



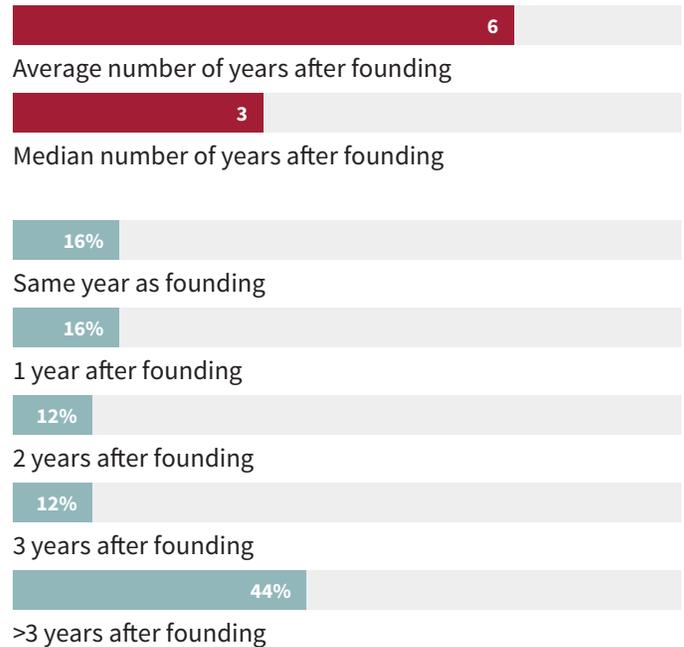


10. [If no to Q9] When did your company hire the CEO who took the company public?

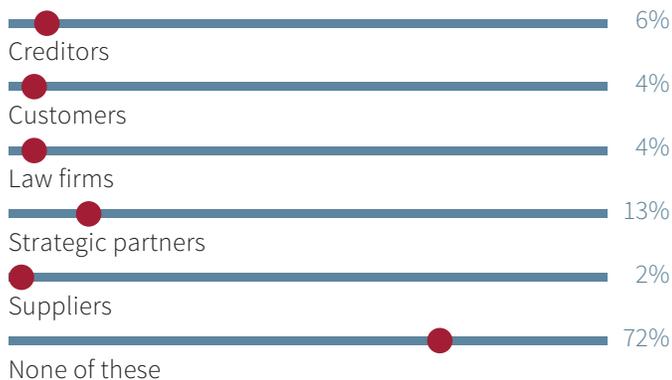
Relative to IPO



Relative to Founding



8. Did the company have directors on its board representing any of the following non-investor stakeholders prior to IPO?



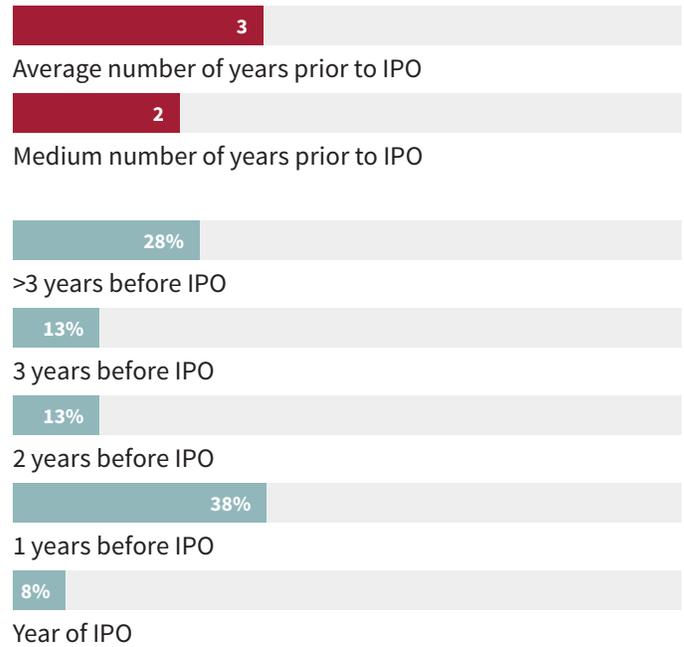
9. Did the founder of the company serve as CEO at the time the company went public?



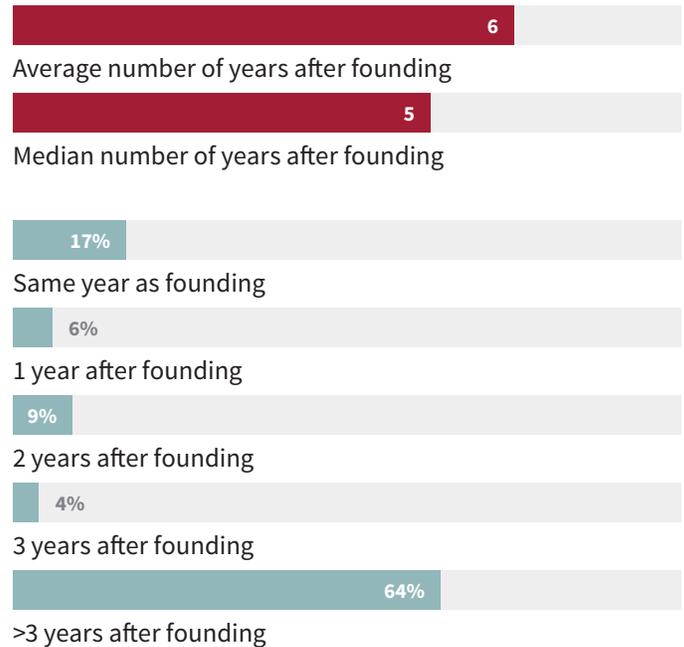


13. When did the company hire the CFO who took the company public?

Relative to IPO



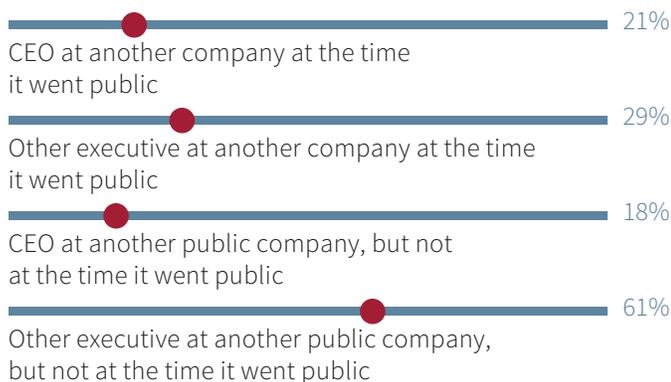
Relative to Founding



11. [If no to Q9] Was this CEO hired with the express purpose of leading an IPO?



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

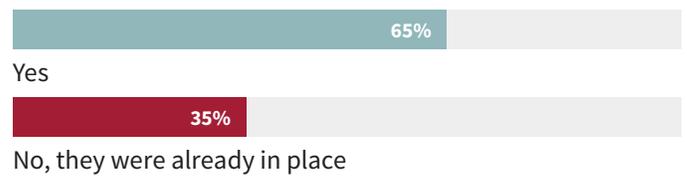




14. Did the CFO at the time of IPO have any of the following experience(s) prior to becoming CFO? (select all that apply)



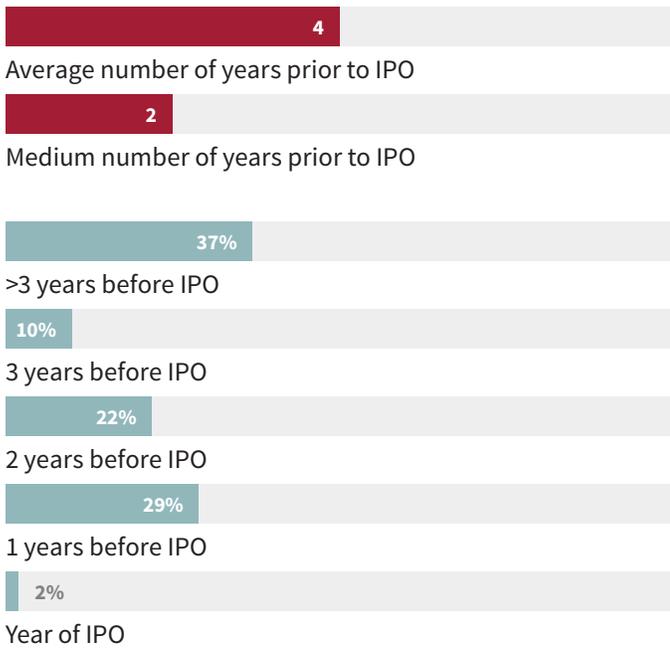
15. Did this CFO oversee the development of the financial and accounting system in place at the time of IPO?



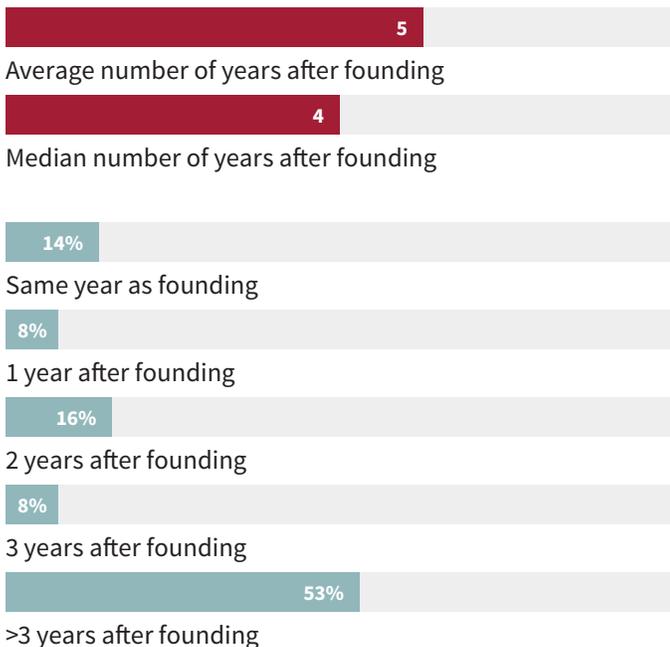


16. Approximately when was this financial and accounting system first put in place?

Relative to IPO



Relative to Founding



“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.”

“You are under a great deal of pressure to be able to demonstrate that you are running a very tight ship when it comes to internal controls over financial reporting and disclosure.”

“Our lenders required us to have audited financial statements from early on, so 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.”

“We had an acting controller for 6 or 7 years before we took the company public. We realized that person did not have the right skill set to be controller after going public, so we talked her into a different position, and we went out and sought a different controller with a strong public company background.”

“Because we were an emerging growth company [under the JOBS Act], we were not required to test the control environment until either 5 years after the IPO or when we reached a certain market cap threshold. That gave us two-and-a-half years, maybe three, post-IPO before we had to have that control environment tested. ... That saved us a lot of money to get ready without having to have that integrated audit.”

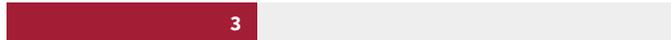


17. When did the company first hire the external auditor used at the time of IPO?

Relative to IPO



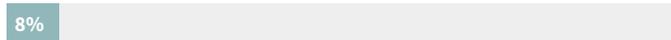
Average number of years prior to IPO



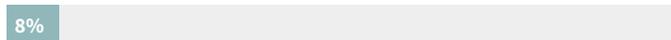
Medium number of years prior to IPO



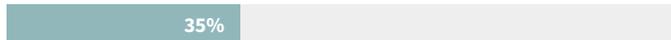
>3 years before IPO



3 years before IPO



2 years before IPO



1 years before IPO



Year of IPO

“Our auditors were from a regional firm. We got to a point where we were constantly having to go to the national office to get opinions on various accounting matters. Because of that we went and found a Big Four firm that had experience in our industry. ... The switch allowed us to leverage.”

“We absolutely had to hire a Big Four firm.”

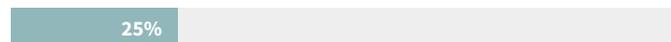
Relative to Founding



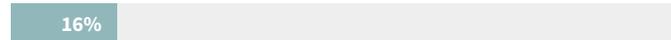
Average number of years after founding



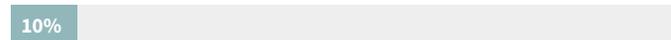
Median number of years after founding



Same year as founding



1 year after founding



2 years after founding



3 years after founding



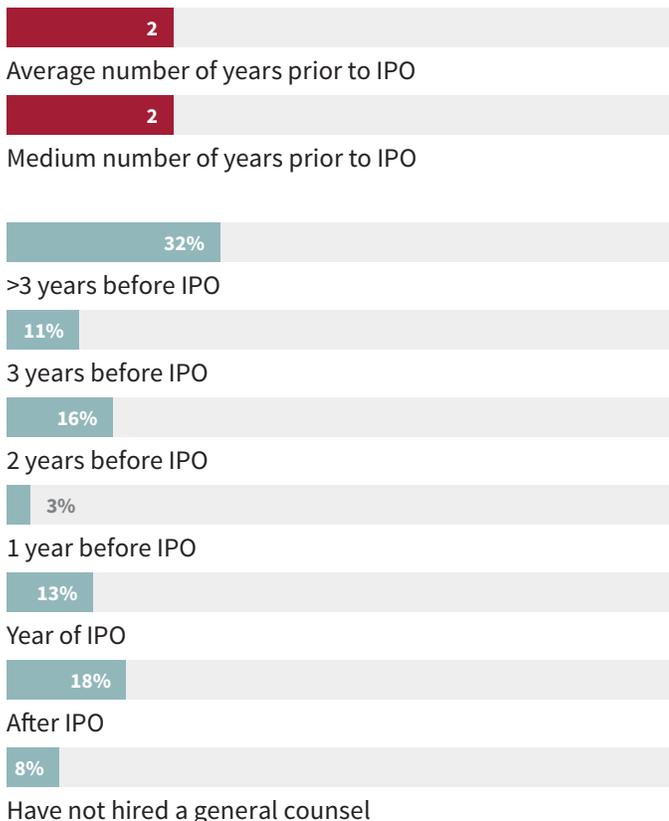
>3 years after founding

18. Did the company use a Big 4 auditor at the time of IPO?

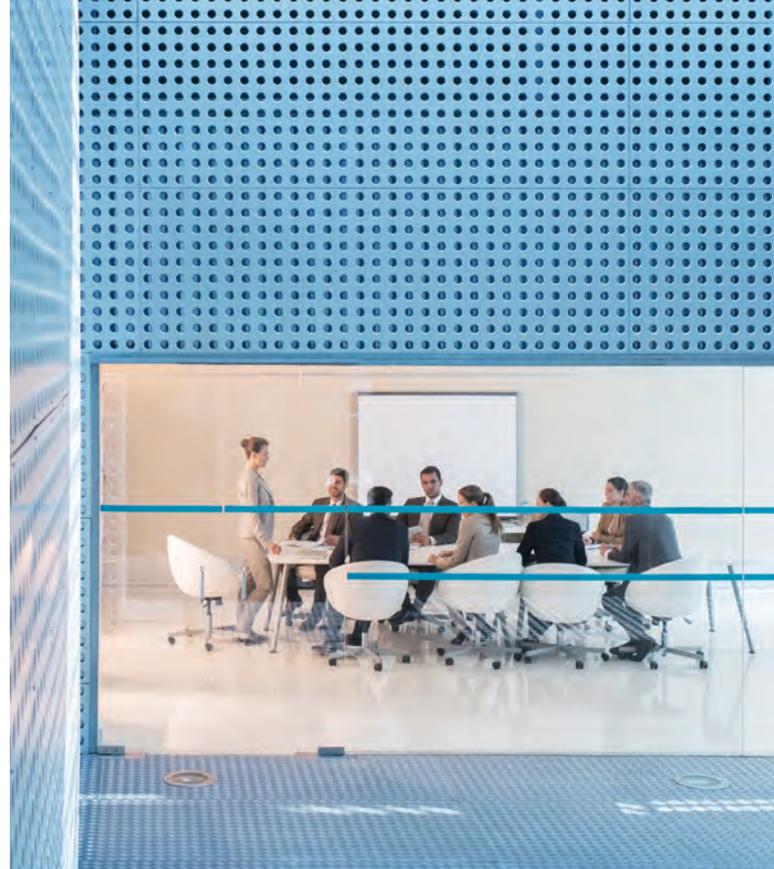
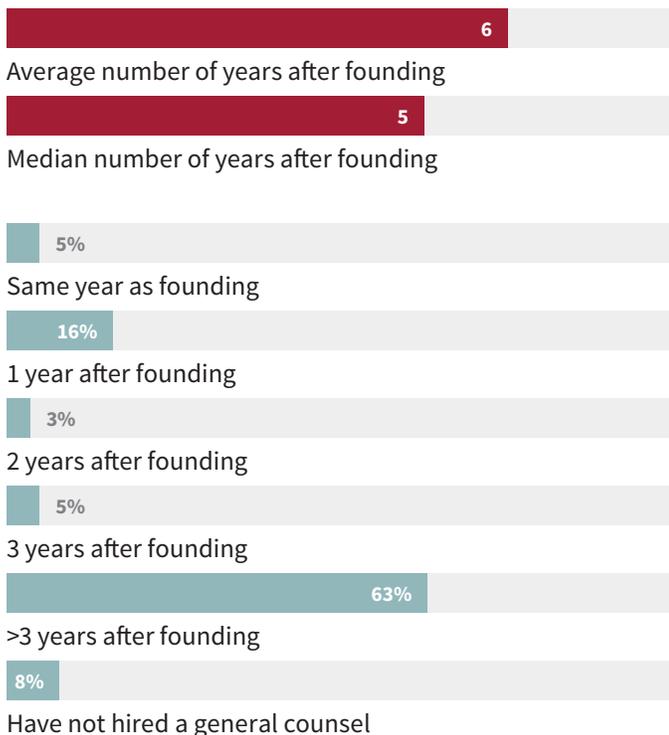


19. When did the company first hire an inside general counsel?

Relative to IPO



Relative to Founding



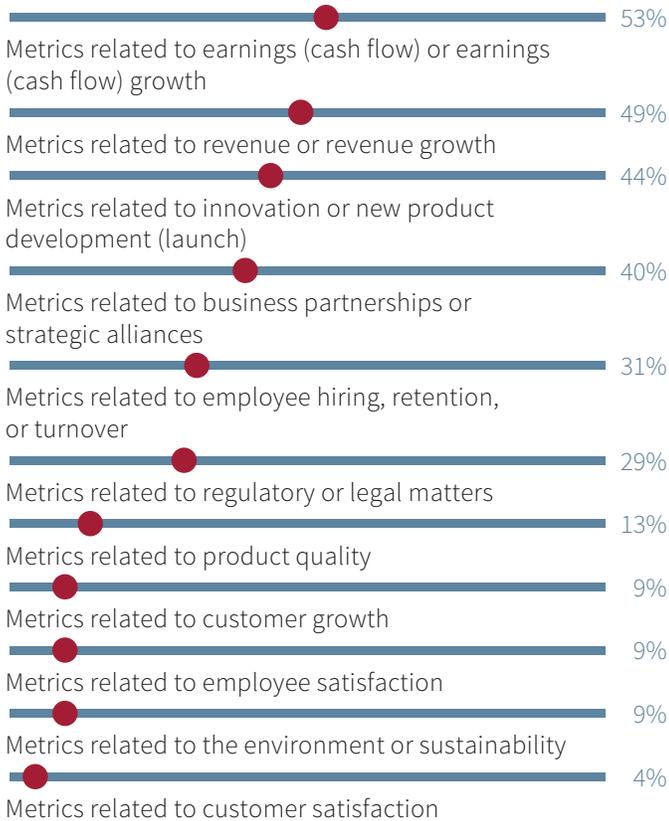
“You need counsel that can give you expert advice about everything around the business. It is very hard to hire that when you are a 50-person, \$20 million company.”

“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, because that individual was not an expert in everything, and was using a ton of outsourced legal teams to get the work done, that 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.”

20. 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).



“We already had a very strong independent compensation committee in place. The chair of that committee has been chair for probably 10 or 12 years. We’ve always separated the compensation piece from the executives. ... That really has not changed at all.”

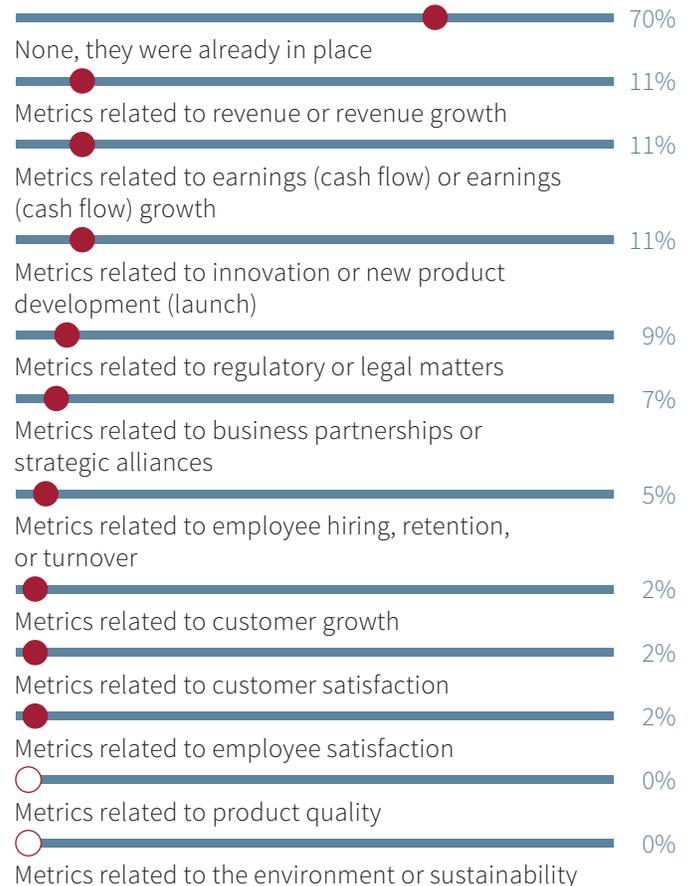
“The difference is night and day. ... As a private company, you have to execute, build product, ship it, get customers, grow, get better customers, make them happy, develop your technology—a lot of things in parallel. We were rewarded on the basis of achieving those strategic goals. ... After you go public you have a group of comparable companies, and you hire an outside firm to advise you on compensation. The leadership team is evaluated vis-à-vis the peer group, and then you file an annual proxy, defining how leadership is paid and on what basis that serves longer-term shareholders. You’re not trying to get to an exit. You are trying to build shareholder value over time. The metrics become clear and published and they don’t vary much year to year, and it is all based on external comparisons.”

“Public company metrics are unsuited for small private companies that are trying to find their way.”

“When we were a private company, we gave yearly bonuses based on milestones. We gave stock options as well, but they were more formulaic in terms of giving a percentage of the company to employees. As a public company, we have a consultant that helps us compare to other companies. It is a little bit more complex ... but we still have the same basic structure: the base salary, a target bonus, and stock-option compensation.”

“After the IPO, we brought in an HR consulting firm to work with the comp committee. We learned that to be public we had to move the cash base pay and bonus pay of our employee base up quite a bit, and we would have to reduce the amount of stock options they were getting to fit within the [ISS] burn limit. We worked with the comp committee to do that transition over a three-year period and laid out to the employees that that is what they would see. We now have our base pay and bonus structure usually within the 50th and 75th percentile and our stock option grants have all fallen within the market ranges.”

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



22. Did the company have a classified or staggered board structure (in which directors are elected to multiple-year terms with a subset of the board standing for reelection each year) at the time of IPO?



“We’ve had a staggered board since day one. We’ve been conscious about not having the entire board turn over in a single year.”

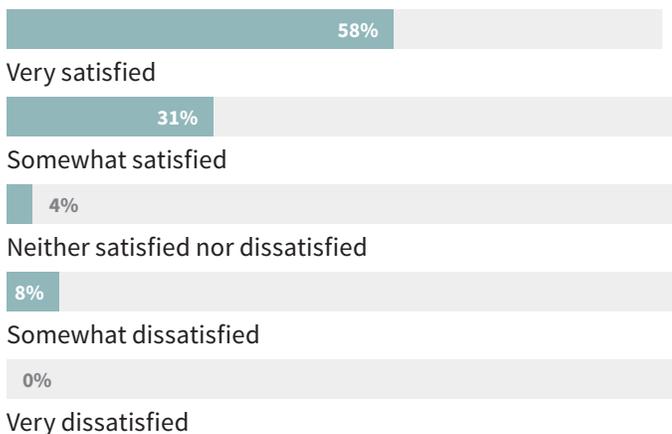
“I think a lot of companies have a staggered board when they go public. We had no pushback whatsoever. I think that’s almost an expected part of the prospectus. ... I never got a question about it at all.”

“We’ve never had a staggered board. The whole vision from the beginning was to be shareholder-friendly.”

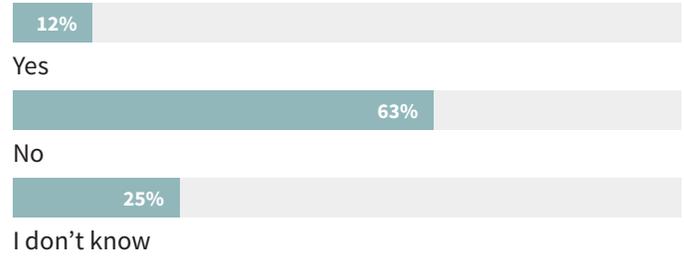
23. Did the company have more than one class of stock with unequal voting rights (“dual-class shares”) at the time of IPO?



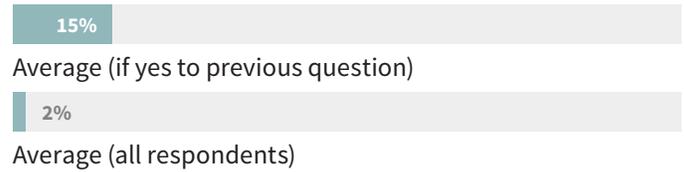
24. How satisfied are you with the quality of the corporate governance system the company had in place at the time of IPO?



25. Did the quality of the company’s corporate governance system have an impact on the pricing of the IPO?



25. What do you estimate was the impact of the corporate governance system on the IPO price?



Additional Comments

“The legal expenses that we incurred to meet SEC requirements were extraordinary.”

“It costs somewhere in the neighborhood of \$5 million a year to be public, just because of the extra reports from our auditors and the legal documentation to meet the requirements of the SEC. It’s a very expensive process to maintain.”

“There is a meaningful overhead cost to being a public company. To some extent you lose a little flexibility. You can still turn on a dime, but you have to document it and report it and write scripts about it and do earnings calls about it. It is an overhead burden and a cost.”

“Having governance in place is expected.”

“It has been a learning venture, and I’m sure it will continue to be as we continue to grow.”



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The Corporate Governance Research Initiative at Stanford Graduate School of Business focuses on research to advance the intellectual understanding of corporate governance, both domestically and abroad. By collaborating with academics and practitioners from the public and private sectors, we seek to generate insights into critical issues and bridge the gap between theory and practice. Our research covers a broad range of topics that include executive compensation, board governance, CEO succession, and proxy voting. gsb.stanford.edu/cgri

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