Chapter 2
Initially Distracted: The Influence of Boards on Agency Costs in Initial Public Offering (IPO) Firms

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Abstract While the process of pursuing an initial public offering (IPO) provides new capital with which new ventures might pursue significant opportunities, research suggests that many IPO firms decrease in value subsequent to the new offering. Using an agency perspective, we argue that the IPO process itself may not only raise direct governance costs (due to increased monitoring and bonding), but may also create a distraction for managers who need to remain focused on the strategy to effectively use a large infusion of capital from the IPO. Likewise, we argue that governance participants, especially board members, will be distracted by the work necessary to take the firm public and, as such, may not be focused on the strategic monitoring necessary for continued firm's viability. This lack of monitoring may also allow managerial opportunism to be more prevalent, especially given the large amount of capital available to managers once the IPO is completed. Accordingly, we argue that excessive governance costs (both direct and indirect) may be associated with the IPO process and subsequent IPO firm performance.

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While the precise degree is difficult to ascertain, the presence of long-run underperformance in IPO firms has been well documented. Ritter and Welch (2002) endorse two explanations of this trend. The first is that the most optimistic investors purchase IPO stocks first and that, over time, as the company gains a track record or as information asymmetries decrease, opinions regarding the actual value of the stock converge toward the mean and the stock price falls (Miller 1977). The second is that IPOs appear in waves, such that highly successful IPOs incite a large number of unprepared followers that perform poorly, thereby dampening the average performance of IPO firms (Schultz 2001).

While these and the other extant rationales discussed below provide some important insights, they do not fully explain the occurrence of underperformance in IPO firms in the years immediately following the launch of their public stock. In this chapter, we adopt an agency theory lens to examine the corporate governance changes that occur at the time of IPOs and the subsequent effects of these changes in contributing to long-run IPO firm underperformance. Our contribution focuses on suggesting that excessive governance costs, both direct (monitoring and bonding) and indirect (through the distraction of managers and board members), may significantly contribute to the lack of

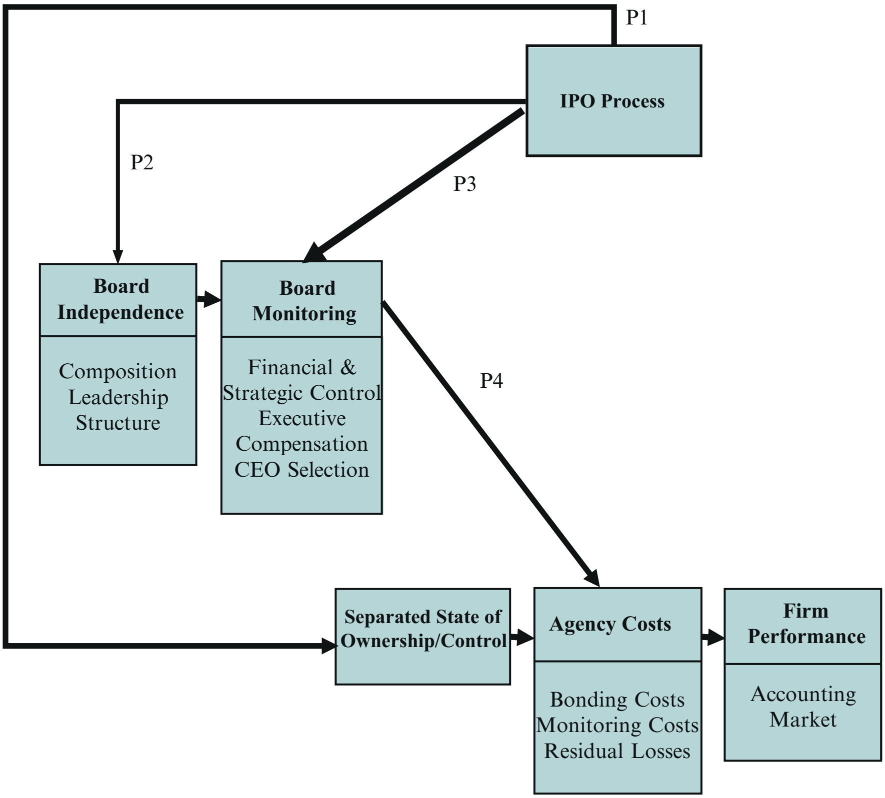

Fig. 2.1 The effect of IPOs on agency costs

long-run performance by newly publicly traded firms. Thus, as we suggest in Fig. 2.1, excessive agency costs may be a critical aspect contributing to low performing IPO firms and even firm failure. This is interesting in that, in theory, the IPO process[1] should allow for improved monitoring and public scrutiny of firms with future potential.

We begin our study with a summary of the tenets of agency theory and the monitoring function of corporate boards. Next, we review studies of the relationship between boards and IPO firm performance. We discuss factors which lead to IPOs and the effect the decision to go public has on board composition and structure. We show how these changes incite board monitoring of IPO-related issues which, although helpful to the IPO process itself, distracts board members from monitoring the core operations of the firm and sidetracks senior managers away from these core operations. We demonstrate how the IPO process produces distractions at the expense of other important issues thus aggrevating the potential for opportunistic behavior by top managers.

One of the contributions to theory that arises from this study pertains to the notion of bounded rationality, a key assumption of agency theory (Eisenhardt 1989), which reflects the fact that, when faced with complexity and uncertainty, human actors are limited in their ability to process and manage information (Simon 1957). The bounded rationality assumption suggests that complexity and uncertainty make it difficult for owners to foresee future contingencies and to form contracts with agents that will maximize the interests of the firm. In traditional agency theory treatments, boards of directors are proposed as a remedy to this problem because they are able to actively monitor the agents, exert pressure, modify incentives, and more fully align agent behavior with principals' interests.

In contrast to this logic, we build upon the assumption of bounded rationality to suggest that the board may also inadvertently contribute to agency costs around the time of major strategic processes (e.g., IPOs). We argue that the complex and rigorous nature of going public distracts the board from other issues within the firm. Owing to bounded rationality and constraints on the time and attention of directors, the board cannot monitor the non-IPO-related activities of the firm as effectively. Top executives may be similarly distracted by the IPO and thus somewhat limited in their ability to supervise the non-IPO-related functions. Accordingly, the problem of distraction can extend throughout the organizational hierarchy as managers involved in the IPO neglect other important duties, opening the door to agent shirking and opportunism at multiple organizational levels. Thus, our work reinterprets the implications of a critical assumption of agency theory and simultaneously spotlights some of the costs of going public which have received less attention in extant research and which can inform owners and other practitioners of the pitfalls they may encounter as they take their companies public.

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[1] The IPO process (as mentioned in Fig. 2.1) begins with the decision to take the firm public and ends with value stabilizing efforts (e.g., creating a market in the new public stock, providing liquidity to exiting investors) after the stock issue. See Ellis et al. (1999) for a helpful examination of this process.

2.1 Literature Review

2.1.1 Agency Theory and Boards of Directors

We begin with a review of agency theory assertions with particular emphasis on the role of corporate boards of directors. Agency theorists treat the firm as a nexus of contracts between owners, employees, creditors, and others. Agency theory advocates (a) efficiency as a means to improve firm performance, and (b) the use of governance mechanisms to manage agency costs as the primary means of improving efficiency (Eisenhardt 1989; Fama and Jensen 1983). The theory also contends that agency costs arise in corporations where owners delegate control to agents (Berle and Means 1932; Jensen and Meckling 1976).

These agency costs include bonding and monitoring costs and residual losses (Jensen and Meckling 1976). Bonding costs are incurred to tie the interests of agents to those of principals and include costs associated with executive employment contracts, explicit bonding against malfeasance, and performance-based executive compensation (Williamson 1988). Monitoring costs are costs incurred to supervise and control the agents and include costs associated with conducting board meetings and recruiting and remunerating directors (e.g., annual retainers, committee retainers and meeting fees, as well as stock compensation in the form of shares and options).

Agency theory contends these (bonding and monitoring) costs are justifiable to the degree they prevent more significant "residual losses," defined as losses from unchecked agent opportunism and the divergence of principal and agent interests. Myriad examples of residual losses exist, including the costs of agents shirking their duties, embezzling or misusing company funds, and consuming excessive perquisites.

Owing to the significant potential of such costs to harm owners, agency theorists emphasize the importance of boards of directors to curb residual losses and enhance firm performance by "monitoring" or "controlling" agent behavior (Hillman and Dalziel 2003; Zahra and Pearce 1989), creating and enforcing budget restrictions and operating rules (Jensen and Meckling 1976), and overseeing strategy implementation (Rindova 1999). As part of their monitoring function, boards have the responsibility of selecting, bonding, evaluating, compensating and replacing top of executives (Conyon and Peck 1998; Pitcher et al. 2000) who are in turn responsible for managing the organization. Because boards of directors sit at the apex of the organization, the decisions and priorities of corporate boards can have a direct effect on top managers and a trickle-down effect throughout the entire control structure or hierarchy of the organization.

2.1.2 Boards and IPO Performance

Given the potential of boards to control top executives and influence the strategy and thus performance of firms, it is not surprising that researchers studying IPOs have considered the influence of corporate boards on IPO firm performance. The agency literature on this topic has been dominated by a focus on two measures of board independence: (a) board composition (e.g., the ratio of outside to total directors) and (b) board leadership structure (i.e., division of the CEO and board chair positions).

Studies examining the link between board composition at the time of the IPO and initial stock performance have yielded equivocal results (see Table 2.1 for a summary). Some researchers find that the percentage of outside directors is positively associated with initial underpricing[2] (Certo et al. 2001) and the percentage of insiders is negatively associated with initial underpricing (Arthurs et al. 2008). Conversely, many others find that the percentage of outsiders is positively associated with higher initial stock returns (Howton et al. 2001) and initial firm value (Roosenboom and van der Goot 2005), and negatively associated with underpricing of the initial offering (Chahine and Filatotchev 2008).

Whatever benefit there may be to independent board composition at the time of the IPO, it seems to wear off in the years following the IPO. In fact, researchers find inside (rather than outside) director participation on the board is positively related

Table 2.1 Board composition and structure and IPO firm performance

Antecedent	Outcome	Finding	Authors
% of inside directors	Initial underpricing	–R.	Arthurs et al. (2008)
% of independent outside directors	Initial underpricing	+R.	Certo et al. (2001)
Separate (nondual) CEO/ Chair leadership structure		N.S.	
% of independent directors	Initial underpricing	–R.	Chahine and Filatotchev (2008)
% of nonaffiliated outside directors	Initial stock returns	+R.	Howton et al. 2001
CEO/Chair duality		N.S.	
% of independent directors	Initial IPO firm value	+R.	Roosenboom and van der Goot (2005)
Outside director control	5-year post-IPO operating performance	N.S.	Balatbat et al. (2004)
Separate (nondual) CEO/ Chair leadership structure		+R.	
Outside director presence	IPO firm survival	N.S.	Howton (2006)
Increases in the % of outside directors	Time to post-IPO operating profitability	–R.	Jain et al. (2008)
Original TMT board participation	2-year post-IPO stock performance	+ R.	Kroll et al. (2007)
Post-IPO division of CEO/ Chair positions	3-year post-IPO stock performance	+ R.	Li and Naughton (2007)

N.S. = No support for a significant relationship between the antecedent and the outcome
+R. = Evidence that the antecedent is positively related to the outcome
–R. = Evidence that the antecedent is negatively related to the outcome

[2] Underpricing is the difference between the initial market price of the offering (e.g., at the end of the first day of trading) and the stock price set by the IPO firm managers and their underwriter.

to 2-year post-IPO stock performance (Kroll et al. 2007). Studies predicting post-IPO operating performance also support this view. For example, Cox proportional hazard models reveal that higher percentages of outside directors lengthen the time it takes for unprofitable Internet IPOs to achieve profitability (Jain et al. 2008). These findings are tempered by other research which reports no significant relationship between outside directors and post-IPO operating performance (Balatbat et al. 2004) and survival (Howton 2006). In sum, studies reveal that independent board composition is not a reliable predictor of long-run IPO firm performance.

Investigations of independent board leadership structures and IPO firm performance also create a perplexing picture. Researchers find that an independent (separated) CEO/Chair leadership structure is not significantly related to initial underpricing (Certo et al. 2001) and, similarly, that CEO/Chair duality is not significantly related to initial-day stock returns (Howton et al. 2001). In the years following the initial offering, however, it seems that nondual structures may enhance IPO firm operating performance (Balatbat et al. 2004) and stock performance (Li and Naughton 2007).

Together, these studies underscore the complexity of the relationship between board independence and the performance of IPO firms. Nondual leadership structures – which do not seem to help initially – may have long-term benefits, whereas independent board composition – which sometimes appear to generate value initially – decline in importance and may even dampen post-IPO performance.

Scholars have tried to explain the long-run underperformance of IPO firms using a variety of perspectives (see Ritter and Welch (2002) for a helpful review of such explanations). One agency theory explanation is that after the firm has gone public and received the associated injection of funds, agents mismanage the newly received IPO funds and thereby produce negative performance consequences (Howton et al. 2001). While such an explanation is consistent with the preceding findings that independent leadership structures add value post-IPO (e.g., by reducing the CEO's control of IPO funds), it does not explain the (nonsignificant and negative) findings related to outside directors and post-IPO performance.

In this chapter, we attempt to address this issue by providing additional reasoning grounded in agency theory. We more fully interpret the bounded rationality assumption and demonstrate how boards are subject to human limits and become caught up in the demands of taking a firm public. We argue that the decision to go public gives rise to changes in board composition and structure, thereby directly producing agency costs, and that these changes tend to increase board monitoring activities in preparation for the firm to go public. We contend, however, that going public may also produce indirect governance costs as well. That is, the demands of going public may distract the board, and consequently top managers and agents at the other levels of the organization, from their primary purpose of running the organization, inadvertently opening a window for increased agent opportunism and residual losses which dampen firm performance. Thus, board monitoring produces both direct and indirect agency costs. As such, we contribute to agency theory by demonstrating how (boundedly rational) boards can contribute to the very same agency costs they were meant to reduce.

2.2 Theory Development

Numerous factors incite private firms to go public. For example, private firms that perform well or are likely to in the future, experience pressure to go public from venture capitalists and other powerful owners (e.g., angel investors) (Gulati and Higgins 2003; McBain and Krause 1989). To the extent public equity investors demand investment opportunities, these entities also lure firms into public equity markets. The need for additional financial capital, the economic outlook, and several other factors may also prompt firms to engage in the IPO process (see Prasad et al. (1995) for a detailed summary of such factors).

When a firm goes public, venture capitalists, angels, and other early owners can exit or reduce their interests in the firm. For example, founders may view the IPO as a chance to relinquish the responsibilities of control and cash in on firm value. Though some founder CEOs may prefer to maintain as much control and ownership as possible (Nelson 2003), there are disincentives for this decision as some researchers find that managers retaining equity this increases underpricing or the amount of money "left on the table" in the IPO (Daily et al. 2003).

Like founders, VCs, in search of a strong return on investment within a relatively short time period (e.g., 5 years) (Zider 1998), often view the IPO as a critical step that moves them closer to recouping their initial investment and any associated returns (Sanders and Boivie 2004). The same is true for family members and other private informal investors who are critically interested in harvesting their investments and who often view the IPO as a means to this end (Prasad et al. 1995).

The sale of equity by owners such as these results in an increase in the degree of separation of ownership and control for the firm. For example, when founders and owner-managers sell their interests in the firm to public equity holders with no management duties, the degree of separation increases because generally, public equity holders have no direct day-to-day involvement with the firm, exert very limited control by voting on only a narrow array of issues presented to them by managers and boards of directors, or may even lack significant voting rights (e.g., nonvoting or restricted shareholders).

Similarly, when VCs sell their ownership stakes to public equity holders at the time of an IPO, the degree of separation of ownership and control widens. Though VCs may not officially "manage" the organization, they can be unusually active in controlling the firm's strategy and operations by participating on the firm's board or through placement of managers in key positions (Fried et al. 1998). Likewise, family members and other early investors don't manage the firm, but they often have strong ties with managers and can exert a degree of control through them (Gomez-Mejia et al. 2001). Accordingly, we suggest that, in the absence of other factors, the exit of any of these owners will likely result in a transition to a more elevated state of separation between those that own and those that control the firm.

Conversly there are also cases where all of the pre-IPO owners maintain their ownership and control of the organization (e.g., founder-managers continue in their management duties, and no pre-IPO equity holdings are sold). However, even in these cases, IPOs still involve outsiders who acquire new public equity holdings in the firm. These new equity holders include investment banks, institutional investors, and many private individuals (Lewellen 2006). As many of these new owners will not share the control of the organization to the same degree as pre-IPO owners, these equity purchases are nonetheless likely to increase the degree of separation between principals and agents of the firm.

In view of these arguments, we formally propose:

Proposition 1: The transition from being privately held to publicly traded via an initial public offering (IPO) will be positively related to a more separated state of ownership and control.

Because IPOs are associated with the separation of ownership and control, investors like to receive assurances that the potential for agency problems in the firm is being mitigated by board governance (Certo et al. 2001). Accordingly, we contend the decision to move a firm into the public equity markets will also be associated with changes in board composition and board leadership structure.

There are numerous reasons why the onset of an IPO influences board composition. For example, firms seeking financial resources often appoint outside directors (Pfeffer 1972), particularly those from the financial community (Stearns and Mizruchi 1993), to the board. Outside "support specialist" directors, including investment bankers, may join the board to facilitate firm access to capital markets (Hillman et al. 2000). Similarly, as a firm goes public, it is subject to powerful investors who can influence who sits on the board (Luoma and Goodstein 1999). Influential investors (i.e., investment banks, institutional investors, large block shareholders) and other stakeholder groups most often focus on increasing board independence in view of curbing agent opportunism (Davis and Thompson 1994; McConnell and Servaes 1990). In fact, in their efforts to influence board effectiveness and protoect their interests, owners may even appoint their own representatives to the board. In addition, when firms conduct an IPO and become listed on an exchange, they become subject to regulators and stock exchange guidelines stipulating that independent outside board members chair or sit on key board committees such as the nomination, compensation and audit committees. Accordingly, we submit:

Proposition 2a: The transition from being privately held to publicly traded via an initial public offering (IPO) will be positively related to changes in board composition, such that boards will be more independent after the decision to go public.

In addition to board composition, the decision to go public may also change the board leadership structure. CEO/Chair duality is common in pre-IPO firms as they are often CEO-centric. Pressure from investment bankers, potential investors and regulators (e.g., the US Securities and Exchange Commission) often lead to more independent boards with divided leadership structures (Certo et al. 2001) upto and potentially including the displacement of the founder who chaired the board and simultaneously acted as chief executive. The argument for such action is that separating the CEO/Chair position will improve governance and that replacing founders with "professional" managers and directors, who are better-suited to the challenges associated with leading public corporations (Fischer and Pollock 2004), may in some cases substantially increase the value of the firm (Arcand 2004).

Together, these preferences for new management and independent boards may increase the likelihood that a new CEO will be appointed from outside the firm and that this new CEO will not chair the board of directors. Even in cases where the founder-CEO is not replaced with a professional outsider, researchers find the founders are less likely to chair the board post-IPO (Nelson 2003). This may be because a divided leadership structure can reduce the potential for conflicts of interest and may increase the odds of vigilant board monitoring. In keeping with this logic, researchers find divided board leadership structures are positively associated with post-listing firm performance (Balatbat et al. 2004; Li and Naughton 2007). Accordingly, we contend IPOs may lead to the separation of dual leadership structures. Thus, we propose:

> Proposition 2b: The transition from being privately held to publicly traded via an initial public offering (IPO) will be positively related to changes in board leadership structure such that duality will be less common after the decision to go public.

From an agency perspective, board independence (in composition and structure) is the primary antecedent of board monitoring. The relationships between board independence and monitoring have been examined extensively so we do not explicate them here. (See Johnson et al. 1996; Zahra and Pearce 1989 for reviews.)[3] We do, however, direct our attention to the influence of the IPO process on board monitoring.

Though board monitoring may occur continuously (e.g., scrutinizing the latest accounting documents, ongoing comparison of financial targets with current performance, monitoring strategic plans and implementation), IPOs create additional opportunities for monitoring. With the decision to go public, board procedures often become increasingly formalized and the duties of directors are liable to increase (Welbourne and Andrews 1996). Boards assume fiduciary responsibility for a larger asset base. They must comply with the formal dictates of regulators. They may be required to participate in more frequent meetings, particularly if they employ strategic controls to monitor management (Beekun et al. 1998). The board may also need to participate in the firm's IPO road show and in communicating the firm's intended direction to potential investors and other stakeholders as the firm enters the public spotlight (Pollock and Rindova 2003). Boards often need to be involved in crafting and approving the company prospectus because it is their fiduciary duty to ensure that when the firm issues its securities, there are no material misrepresentations or omissions in the registration statement. Litigation involving directors who fail to fulfill this duty provides an incentive for directors to actively participate in their monitoring function around the time of an IPO (Altschul 1986).

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[3]Given the challenge of gaining access to board members and boardrooms, it is worth noting, however, that many studies use firm performance in place of actual measures of monitoring behaviors. See Gulati and Westphal (1999) and Huse et al. (2005)) for recent exceptions.

In addition, the board may need to add members to its ranks in order to satisfy potential investors or regulators, a task which has become more daunting owing to the heightening of director liability due to the Sarbanes-Oxley Act of 2002 (Scherpenseel 2004). After the firm has selected an underwriter, boards need to monitor the actions of bankers who tend to underprice IPOs and may do so at the expense of the initial shareholders in an attempt to generate loyalty among their syndicate banks and clients (Prasad et al. 1995). After the issue, boards continue to monitor underwriters to encourage them to follow through in creating a market in the new stock by trading shares and providing liquidity to investors. Similarly, boards may also have to weigh the benefits and determine the nature of antitakeover provisions when going public, as incumbent managers often push for them (Daines and Klausner 2001) despite the fact that takeover defenses can damage IPO firm value (Roosenboom and van der Goot 2005). These supplementary tasks associated with IPOs provide boards with the increased need to monitor. Accordingly, we suggest:

> Proposition 3: The transition from being privately held to publicly traded via an initial public offering (IPO) will be positively related to board monitoring, such that board monitoring will be higher after the decision to go public than before.

Given these and other monitoring activities around the time of the IPO, we predict higher bonding and monitoring costs. For example, boards often replace the CEO before the IPO (Daily and Dalton 1992) and engage in executive compensation negotiations to bond the new executives' interests with those of the owners. Renegotiating the CEO employment contract (with an incumbent executive or a new arrival) at the time of the IPO often leads to higher bonding costs. Supporting this view, researchers find higher executive compensation is likely when the founder CEO is replaced by a professional (He 2005; Wasserman 2006).

Owing to the risky nature of IPO firms, investors like to see evidence that executives' interests are aligned with their own or that adequate bonding has been arranged (Sanders and Boivie 2004). Accordingly, researchers find that, at the time of the IPO, boards often implement incentive (or "pay-for-performance") compensation schemes (Allcock and Pass 2006), which reward executives handsomely if the firm performs well. Also, because the asset base (size) of the firm increases at the time of the IPO and because executive compensation is positively associated with firm size (Barkema and Gomez-Mejia 1998), boards and owners may need to reconfigure compensation plans in order to pay executives of IPO firms competitively.

In addition to using compensation to tie executives' interests to those of shareholders, firms commonly increase director and officer insurance policies around the time of IPOs, at significant cost (Towers 2007). Thus, they engage in extensive bonding to (a) avert agent actions that could harm shareholders, and (b) insure against, or provide remuneration in the face of, such actions. In view of these arguments, we submit:

> Proposition 4a: Board monitoring activity at the time of an IPO will be positively associated with bonding costs, such that bonding costs will be higher after the decision to go public than before.

While we expect the board activities during the IPO to have an influence on bonding costs, we also anticipate board monitoring costs to increase. As demonstrated above, the IPO provides the board with a significant amount of additional work and liability, which may easily justify an increase in their compensation. In addition, because the board itself is responsible for setting top executive compensation (Baysinger and Hoskisson 1990), the issue of remuneration will often become salient to the board around the time of the IPO. Since boards are empowered to adjust their own compensation as well as that of top executives (Dalton and Daily 2001), we anticipate that, justifiability, salience and empowerment may all lead to increases in board compensation.

The need for accountability may also prompt changes in board compensation, though the potential impact of these changes is less certain. For example, market pressures may prompt a board to use operational or financial controls to motivate its members or prompt board members to accept lower compensation when the board is staffed with higher percentages of insiders (Boyd 1994). Board members may be required to participate in meetings to maximize their pay, or director compensation may be more tightly coupled with firm performance outcomes (Kosnik 1990), which may increase the upper and lower limits of board compensation. Accordingly, we contend that IPOs may lead to numerous changes in board compensation.

In sum, because environmental pressures (Pfeffer 1972) favor increases in the number of directors at the time of the IPO and because board compensation (an important monitoring cost) is the aggregate of director compensation, we expect the costs of remunerating directors will increase with the IPO. Owing to the increased demands on the board to meet and monitor brought on by the decision to go public and the rest of the IPO process which were discussed previously, the costs of operating the board are also likely to increase. These include the costs of travel, food, and accommodations for board meetings, as well as the time and expense associated with preparing documentation and reports for such meetings, among others. In all, we expect the decision to go public will be positively associated with higher monitoring costs. This view is bolstered by the fact that the same people (i.e., board members) who engage in these additional meetings and monitoring activities are responsible for allocating funds for monitoring and adjusting their own compensation. Accordingly, we formally submit:

> Proposition 4b: Board monitoring activity at the time of an IPO will be positively associated with board monitoring costs, such that board monitoring costs will be higher after the decision to go public than before.

In the preceding propositions we have argued the decision to go public gives rise to increases in board monitoring activities and in associated bonding and monitoring costs. We now turn our attention to the influence of increased monitoring activities on residual losses. Agency theorists traditionally argue that the costs of bonding and monitoring are justifiable to the degree they prevent residual losses (Jensen and Meckling 1976). Thus, if boards shirk their duties and do not monitor sufficiently, the opportunistic behavior of agents will lead to harmful residual losses (Fama and Jensen 1983).

It is our contention that, in the context of IPOs, this view may be overly simplistic. That is, a board of directors may be actively engaged in performing monitoring duties (related to the IPO), yet still overlook important aspects of ongoing firm functioning, and thereby open the way to agent opportunism. We note that this suggestion is (a) completely in harmony with agency logic, which places limits on human reasoning and capacity (i.e., bounded rationality) (Eisenhardt 1989), and (b) seems most likely if the board is involved in monitoring important strategic decisions (such as those associated with IPOs) and their implementations. To illustrate our argument, we review the aspects of the IPO process and board involvement therein.

Firms typically do not decide to go public overnight. In fact, the decision to go public is often part of a larger series of strategic decisions and events that involve the board and senior executives. For example, IPOs are used as a vehicle to facilitate the privatization of government-owned firms (Gu 2003). They are pursued by large corporations including those whose entrepreneurial endeavors lead to equity carve-out and lettered stock IPOs.[4] In diversified firms, spinoffs (Bergh et al. 2008), which result in a piece of the corporation breaking off through a new offering (IPO), are sometimes evaluated as an alternative to selloffs (Kingstone et al. 2002); whereas in small firms, IPOs provide an alternative to debt financing, alliances, and mergers, through which the focal firm might otherwise gain access to needed capital.

While the decision to go public requires a great deal of board involvement, that choice only initiates more work for directors. The boards of successful IPO firms engage in extensive preparations for the initial offering including changing executive and employee compensation schemes, developing antitakeover provisions, adjusting accounting and reporting systems, improving strategic planning systems and investor relations capabilities and policies, selecting an underwriter, and courting prospective investors (Ellis et al. 1999). Board member and executive owners must decide how much stock to retain and when they will cash in their stakes after the required lockup period (Daily et al. 2003). They often replace top executives and debate the merits and drawbacks of issuing warrants (How and Howe 2001) and dual-class shares (Amoako-Adu and Smith 2001) in the offering.

Researchers find these preparations take up to 18 months to accomplish and, accordingly, describe the IPO process as an "ordeal" or a "rite of passage" rather than a mere transaction (Champion 1999, p. 17). For this reason, some senior executives have avoided the IPO process altogether. For example, Supply Dynamics (a supply chain aggregation firm which services the global airline manufacturing industry) was recently sold by Trevor Stansbury to O'Neal Steel (a $2.3 B metals service company). While benefiting from the resources O'Neal could provide, Supply Dynamics has retained its management team and operates independently as a subsidiary of O'Neal. In a recent interview we conducted, Stansbury explained why this transaction was preferable to an IPO: "If we were to have invested the time and resources required to go public, it would have invariably meant a major

[4] Equity carve-outs and the issuance of lettered stocks are common elements of corporate entrepreneurship strategies. In equity carve-outs, the parent corporation takes a subsidiary public by creating a new legal entity and often retains a controlling interest in the new IPO firm. In the case of lettered stocks (also referred to as tracking stocks or targeted stocks) no new entity is formed, but the parent uses an IPO to issue new stocks in a subsidiary or division so that it can be "targeted" by investors and tracked by analysts separately from the parent firm (Frank 2001).

distraction and a loss of focus. As a growing SME, we could not afford to take our eyes off the ball" (personal interview, June 2008). While the IPO may be the preferred alternative for many firms, it is nevertheless a labor-intensive process, which has only become more demanding since the passing of Sarbanes-Oxley and similar legislation around the world.

Because of the time and effort involved in taking a firm public, board meetings can become consumed in reviewing IPO-related agenda items and progress. Directors and some top executives (e.g., those responsible for the finance, accounting, and legal functions) are also likely to be distracted with preparations for and involvement in the IPO. While board members and some top managers may be anxiously engaged in preparing and taking the firm public, other senior executives and agents at the other levels of the organization are less likely to have equally demanding roles in the IPO process and remain responsible for the ongoing operations of the firm. To the extent boards are focused on making the IPO a success, they may be less available to monitor the normal operations of the business and less likely to deter agent opportunism, to the extent it exists. Because IPO preparations span an extensive period of time (Champion 1999), board members and senior executives can be distracted for extended periods. Neglect of other areas and issues in the firm can lead to opportunity costs and open the door to agent opportunism, which can go unchecked while directors and officers are engaged in the IPO process.

The case of myCFO Inc., a financial services company which serviced the Silicon Valley elite, provides a helpful illustration (Waldman 2007). The firm's founding owners and board members included James Barksdale, James Clark, and John Doerr (all founders of Netscape Communications), John Chambers of Cisco Systems Inc., and Thomas Jermoluk, past chairman of Excite@Home, among other notables. Signs of trouble emerged as early as 1999, when accountants at myCFO Inc., began showing concerns about the "tax elimination" products that were a lucrative area of the business. One such tax shelter, known by the acronym "Cards", allowed clients to shelter $50–100 MM from tax liability with a foreign debt mechanism. Kevin McAuliffe, a myCFO accountant, raised concerns about such shelters to the board and top executives including CEO Art Shaw during the period in which myCFO was preparing to go public. Unfortunately, excitement about the firm's possible IPO was all-consuming and his concerns fell on deaf ears. While the board and senior executives deliberated over the IPO, the US Internal Revenue Service declared that Cards were improper tax shelters. Subsequently, numerous tax-fraud indictments were made against myCFO employees and the assets of the company were sold in 2002 to the Bank of Montreal and others.

Cases such as this reveal that because preparing for an IPO is so intense, it can distract the board from adequately monitoring other operations in the run-up to the IPO. They also suggest that directors may hesitate to adequately monitor or scrutinize profitable strategies and products around the time of the IPO because they don't want to turn up something that could threaten the success of the IPO and the personal benefits they stand to receive through the IPO-related appreciation of their stock and options.

We further contend that agency problems may persist during and after the IPO as well. When a firm goes public, significant attention is focused on the planned allocation and use of the new IPO funds. Goals and projections are shared with analysts, media representatives, and potential investors to build excitement around the new issue (Ellis et al. 1999). Once the firm receives the injection of capital, top managers must be ready to move forward with their plans; which often involve capital investments, including property, plant, and equipment purchases and upgrades, debt repayment, domestic and international market expansion, workforce growth, investments in innovation, and corporate acquisitions, among others. All of these activities need to be monitored to ensure that the executives do not misuse IPO funds.

The importance of post-IPO monitoring is illustrated by recent IPO scandals where board monitoring was lacking. For example, the Betonsports IPO, in which IPO funds were used to acquire online sports gambling entities operating illegally in the US, resulted in racketeering and fraud charges against senior company officials (Pimlott 2007). Monitoring was also problematic during the eChapman.com IPO, in which senior officers, including CEO Nathan A. Chapman, were accused of using IPO funds for personal use (e.g., home financing, gifts for significant others) and received extensive fines and jail time for defrauding a state pension fund (Jarboe 2004).

To avoid scandals such as these, it is imperative that board members actively monitor the agents responsible for the disposition of IPO funds. Not surprisingly, this is a daunting challenge for busy directors, many of whom are chief executives of outside companies (Useem 1993) and have already committed their time and resources preparing the company to go public. In view of the demands placed on board members in the run up to the IPO, the post-IPO push for expansion may simply be overwhelming. Even if directors manage to stay on top of post-IPO growth, it is easy to conceive of scenarios in which agency problems pertaining to the core business are neglected by the board.

To illustrate, suppose a corporate board pushes for cost reductions and the Vice President (VP) of Operations responds by implementing new efficiency metrics. However, as the prospect of going public takes root and IPO preparations begin, no one may ask for a progress update. As the VP attempts to report back to the board on the progress being made (or the lack thereof), IPO-related agenda items repeatedly take precedence. When the VP asks for funds to expend in pursuit of the sought-after efficiencies, the board refuses on the grounds that expenses must be delayed in order to strengthen the income statement around the time of the IPO. The VP of Operations soon realizes that efficiency is not a top priority and is less likely to endorse and supervise the new metrics. To the extent apathy, shirking, and other forms of opportunism go unchecked at higher levels of the organization, awareness of such activities and replication of them throughout the organization begin to occur (Carr and Brower 1996).

Unfortunately, when the firm receives the large infusion of funds from the IPO, these and other agency problems also occur. The attention of the board and top executives now center on spending the new capital (e.g., building a new manufacturing plant or funding a geographic expansion) and so the manufacturing inefficiencies may be allowed to persist, and agent apathy and opportunism can become ingrained. At the same time, owing to the size of the injection of capital, the board is likely to encourage top managers to move forward promptly with pre-IPO plans for growth since utilizing the newly received capital is necessary for the firm to generate adequate returns for investors. Unfortunately, these plans may not be optimal because they were conceived before the IPO, at a point in time when the amount of capital the IPO would generate could only be roughly estimated. Accordingly, pressure from a board that is striving to fulfill its monitoring function may inadvertently prompt executives to prematurely move forward with projects that are not as well conceived as they could be. Thus, a well-intentioned board working for investors may push executives to act inefficiently. Sadly, experimental research suggests that executives may be particularly susceptible to escalation of commitment at this intermediate stage of the implementation (He and Mittal 2007) when the IPO has yielded funds that must now be used.

In summary, the real-world examples and scenarios reviewed above emphasize the demands IPOs place on directors and the challenge of effectively monitoring the IPO process. While an IPO may be the best course of action in many cases, we contend the demands on boards in preparing for an IPO and dealing with its aftereffects create numerous distractions and burdens that deter them from effectively monitoring both the core operations of the firm and the use of new funds obtained from the IPO. We expect this to result in agency costs and poorer operating performance in the years immediately following the IPO, when IPO funds are being used to implement dramatic growth-oriented changes. Formally stated:

> Proposition 4c: Board monitoring activity related to the IPO will be positively associated with residual losses related to distractions away from the core activities of the firm and the inefficient use of IPO funds.

2.3 Discussion and Conclusion

This chapter provides an alternative explanation to the underperformance of IPO firms in the years immediately following the listing. Our rationale for this troubling phenomenon differs from those currently available in the literature. It is grounded in agency theory and rests upon the assumption that, like senior executives, who are the traditional objects of agency theory criticisms, directors are also fallible human actors who are limited by bounded rationality and time constraints (Hambrick et al. 2005). As Baird and Rasmussen (2007: 924, 928) aptly note, a firm's directors "are part-timers. They have day jobs.… [D]irectors do not curtail their other activities once they join the board. Because they are part-timers, there are real limits on how much time they can invest in… the affairs of the corporation.… Part-time directors cannot be full-time police officers." We contend that, when faced with the rigors of taking a firm public and then monitoring the use of new IPO funds, boards of directors are likely to focus their limited time on IPO-related monitoring, such that they routinely overlook matters pertaining to the more stable ongoing operations of the firm. In effect, IPO-related decisions and events create distractions that deter the directors from governing the firm holistically.

In addition to the distractions, many directors are newly appointed at the time of an IPO and may not sufficiently understand firm operations to make the highest quality decisions. Likewise, often there are CEO changes in IPO firms as entrepreneurs step down, making room for more professional managers. As such, there may be several changes in both the management and monitoring functions of the IPO firm. We suggest these and other chaotic changes associated with taking a firm public open the door to distractions which lead to the neglect of core operations, shirking and other forms of agent opportunism and lead to residual losses which damage firm performance. Our logic that other categories of agency costs – namely bonding and monitoring costs – increase with the IPO as well, thereby creating further direct and indirect costs, also contributes to the explanation of IPO firm underperformance noted earlier.

Our observations regarding the role of boards in IPOs suggest firms moving toward the public equity markets may be wise to consider ways to minimize the effect of the distraction that the IPO process typically entails and to concomitantly develop ways to ensure that other monitoring is not neglected. Our analysis would counter-intuitively discourage IPO firms from staffing their board with directors maintaining several other directorships as these additional directorships may only distract directors further. Instead of staffing the board with individuals serving on several other boards, it may be preferable to staff the board with individuals who have personally gone through an initial public offering (as either a manager or a director). Experience with the IPO process among board members is likely to be particularly valuable for IPO firms seeking to reduce agency costs and recent research finds this to be true (e.g., Arthurs et al. 2008). Furthermore, it appears that board member experience with other new ventures may be invaluable as well (Arthurs et al. 2009). However, we should note that recent changes, particularly those enacted by Sarbanes-Oxley in the US and similar governance legislation in other parts the world, may limit the availability of experienced board members as the liability, requirements, and associated headaches for directors increase their reticence to serve on new boards. Accordingly, Sarbanes-Oxley and similar legislation may have the unintended effect of reducing the effectiveness of boards, particularly those of new ventures preparing for their IPO. We believe that important opportunities exist for scholars to use our ideas as a means to predict the outcomes associated with IPOs, particularly by comparing the impact of Sarbanes-Oxley legislation on the effectiveness of IPO-era firms.

While we have focused on IPOs, we believe much of our logic applies to other significant strategic processes as well, including large mergers, joint ventures, and privatizations; any of which may be sufficiently complex and time consuming to press the limits of a board's capacity. The importance here is that the introduction of a transition in an organization's legal form, a large change in firm capital structure, or some other significant firm event outside the course of normal operations introduces enormous distractions for directors who would otherwise be involved in monitoring the normal activity of the firm. When these change processes extend over a long period of time, our analysis would indicate that agency costs (both the direct costs of monitoring activities and the indirect costs of managerial and board distraction, as well as agent opportunism) can increase, rapidly undermining firm performance.

In conclusion, we have sought to explain why IPO firms may experience poor performance subsequent to going public. While there is little consensus among scholars for explanations of this poor performance, we have developed arguments using agency theory to explain why monitoring may diminish through the IPO process itself. And we have argued that this may lead to longer term problems given the massive influx of capital at the time of the IPO. In particular, we have identified how the IPO process not only increases the separation between ownership and control, but also creates a distraction and a drain on attention limiting the ability of directors to monitor normal operations. Our analysis points to the need for boards to develop coping strategies such as the appointment of directors with experience with the IPO process itself to ensure that the IPO process does not give rise to agency problems.

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