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The Board's Expanded Role in an IPO

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Improvements in market conditions are prompting the boards of many private companies to again consider the possibility of an initial public offering. The board has always played a vital role in a company's IPO, from making the threshold decision to go public to selecting the managing underwriters, approving the final offering terms, and overseeing the entire IPO process. In recent years, disclosure, corporate governance and control requirements have mushroomed, market expectations for IPO companies have increased, and directors of public companies have become subject to greater personal risk. As a result, the board must now be more deeply involved in the IPO process.

IPOs have become more demanding for everyone involved. Preparation is more extensive and time-consuming. SEC review of the IPO registration statement takes longer and is more rigorous, and the average timeline from initial filing to pricing has doubled over the past decade. At the same time, the bar has been raised for aspiring public companies. In 1999, the median annual revenue of all U.S. IPO companies was \$18 million, and only 26% of them were profitable. Median annual revenue of IPO companies is now over \$100 million and most are profitable.

Moreover, the specter of personal liability for directors has never been more real. Directors (along with the CEO and CFO) can be liable for material misstatements or omissions in the registration statement. Following the IPO, similar liability can arise for material misstatements or omissions in the company's annual Form 10-K, and directors are often added as defendants when securities lawsuits are brought. D&O insurance and indemnification arrangements can mitigate the financial exposure, but cannot fully compensate for the distraction and reputational harm that often accompany litigation.

Against this backdrop, the board needs to be directly involved in several key aspects of the IPO process:

Prospectus: Historically, the board reviewed the IPO prospectus before filing but played little role in its preparation. With the substantial expansion in corporate governance requirements and executive compensation disclosure requirements, including many topics on which the board's input is indispensable, the board should now anticipate more extensive involvement with the preparation of the prospectus.

Corporate Governance: The corporate governance revolution of recent years has spawned numerous new requirements. Many are directed at board functions and the relationship of the company to its stockholders, while others fundamentally affect the relationship of the board with company management (for example, should the CEO also be the board chair?). The board and its committees must fashion governance policies and practices that satisfy SEC and stock exchange rules, meet investor expectations, and enable the board and company to function effectively.

Financial Oversight: The board—and particularly the audit committee—has an oversight obligation with respect to the hiring of financial management and the selection of the independent auditor. New SEC rules require disclosures about risk management, and the recently enacted Dodd-Frank Act requires public companies to “claw back” incentive-based compensation paid to executive officers during the three-year period preceding an accounting restatement to the extent such compensation was based on erroneous data. In addition, the company should be confident of hitting its financial targets following the IPO, since a significant shortfall could batter the stock price and attract lawsuits against both the company and the board. These factors—in the context of larger and larger IPOs—raise the stakes for the board’s financial oversight obligations.

Controls: Public companies must satisfy various financial reporting and disclosure control requirements. Although full implementation is not required before the IPO, advance preparation is necessary so that the company can comply once it is public. Company management has primary responsibility for the development of internal controls; the board’s oversight obligations extend to the timely and appropriate development of these controls.

Bottom line: the IPO world has become much more complicated. In discharging its oversight responsibility for the IPO process, the board must now be more involved than ever before.

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