The Role of the Board of Directors In the Successful Startup of New Ventures

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Abstract

Startup is considered the most difficult time in a venture's life. It is a period when critical decisions must be made about how to structure, position and finance the venture, amidst the greatest level of uncertainty the firm may ever face. Successfully managing under such uncertainty requires that the entrepreneurial team either possess extraordinary skills or utilize the expertise of outsiders. While the benefits of a board of directors are well understood for more established firms, there is relatively little known about how an active board can influence new venture success at the startup stage. This paper examines the appropriate role for an active board of directors at startup. Implications for both scholars and practitioners are discussed.

"*Startup*" Defined

Businesses experience a variety of special situations as they grow and mature (Singer, 1995). One of the most unique periods in the life a venture is its *startup*. Startup is that period of time between when the business idea is conceptualized and when the new venture achieves a satisfactory level of stabilization in its day-to-day operations. This stage of development consists of three distinct phases: pre-entry; market entry; and early growth (Kuratko and Hodgetts, 1995). Though the characteristics of startup are relatively common across different types of ventures, the duration of startup can range from one to five years depending on the experience of the entrepreneurial team and the complexity of the new opportunity. Experts report that the failure rate for startups is approximately 25 percent within the first two years and as much as 65 percent in the first five years (Dennis, 1993). It is a period when critical decisions must be made amidst the greatest level of uncertainty the firm may ever face. This includes uncertainty about critical matters such as the size and growth of the market, the reaction of entrenched competition, the demand for the new product or service, the availability of key resources, the feasibility of innovative technologies, and the timing of the window of opportunity.

Experts agree that there are three crucial components needed for the startup of a successful new venture: an opportunity, an experienced entrepreneur or entrepreneurial team, and access to critical resources (Timmons, 1997). Opportunities consist of product/service ideas that tap existing or developing market needs. The entrepreneur or

entrepreneurial team provides the industry, management, and startup experience necessary to successfully pursue the opportunity. Effective resource management involves minimizing overhead costs, maximizing productivity; and limiting capital asset requirements. The decisions involved in successfully starting a business venture require the entrepreneur to establish a "fit" between these core elements so as to minimize the amount of resources needed and to maximize the effectiveness of those resources that are available (Timmons, 1997). The unique decisions faced by the entrepreneur and the lead management team in each phase of the startup process are briefly described below.

Pre-Entry (1 - 12 months)

Pre-entry is that period when the business idea is conceptualized and the plans are formulated for market entry. The substance of each plan depends to a large degree on the intentions of the lead entrepreneur. His or her focus is typically on the opportunity and on minimizing the amount and cost of resources necessary to pursue the opportunity. The entrepreneur has determined that the business idea is feasible and attempts to design an organization to pursue specific objectives. Most of his/her energy is spent scanning the environment, developing the appropriate entry strategy, marshaling resources, and completing any details in the final product/service offering.

Many aspects of the pre-entry situation are uncertain, including: the size and nature of the market; the strategy and position of leading competitors; the costs of materials, equipment, facilities and capital; the role of the management team, and the most effective market entry strategy. For many new ventures, future success can literally ride on whether the entrepreneur successfully positions the new venture in the marketplace based on their judgments about the market in the pre-entry stage (Naffziger and Kuratko, 1991). The pre-entry phase of the startup process is where the entrepreneur relies most heavily on his/her industry experience. Successfully designing an organization while using information highly prone to error requires an in-depth, working knowledge of how the market works and what the key factors are for competing successfully.

Market Entry (6 - 18 months)

Market entry refers to that period beginning with the first customer order or sale and extending until the planned distribution, sales, and manufacturing operations are firmly established. The entrepreneur drives this phase of the process, however, a great deal of the day-to-day implementation of the entry plan is delegated to the management team. Though the initial plans for the venture are still in effect, the results of implementing the plan derived from careful evaluation begin to drive the entrepreneur's decision-making process at this phase. The market entry phase is said to be completed when the initial plans are sufficiently satisfied and management can turn its attention toward stabilizing the operations. This phase can be as short as six months for relatively simple business concepts, or as long as 18 months where multiple facilities in multiple locations with unique strategies make it difficult to coordinate in a short time frame.

The lead entrepreneur or the entrepreneurial team is focused on operationalizing the business plan at this phase. All managerial energies are directed toward accomplishing very specific short-term goals, such as: securing properties and lease arrangements, constructing facilities, closing on capital programs for sources of funds, securing the early management team, and serving the initial customers. Market entry represents a period in the life of the new venture where the entrepreneurs strives to validate many of the assumptions under which the entry plans were developed during pre-entry. It is also the point at which the lead entrepreneur begins to test many of his/her initial ideas about the future of the business and whether the idea possess the same level of value as originally believed.

The entrepreneur's startup experience is most critical at this phase. Stakeholders rely upon the entrepreneur to closely monitor the day-to-day implementation of the plan, to control costs, coordinate with initial customers, and troubleshoot problems in the original plans and to reformulate strategy as the business makes its early moves to position itself in the marketplace.

Early Growth (24 - 48 months)

The focus of the early growth phase of the startup process is on stabilizing the operations, or reaching a point of legitimacy for the new venture. Stabilizing operations is the most time consuming startup task and can be the most complex for the lead entrepreneur. This period is characterized by a moderate level of uncertainty given management's preparation for accelerated growth. Various financial and operational control systems are being designed as a result of successful market entry and a greater understanding of how to effectively compete in the chosen market.

The role of the lead entrepreneur at this point is two-fold: bringing stability to the growing operations and setting the future growth agenda. His or her role moves beyond that of the visionary, a role necessary in the earlier stages of the process, and shifts to that of a true leader. It is exactly this role transition which makes this phase of startup the most difficult for the lead entrepreneur and his or her team (MacMillan, 1983). They often struggle with which areas of responsibility need their close control and which can be effectively delegated (Osborne, 1991). Though the process can be difficult, most entrepreneurs understand that the single greatest threat to the future growth of the business is their inability or unwillingness to delegate as their own role changes (MacMillan, 1983). This is why the management experience of the entrepreneurial team is most critical at this stage. The team is now firmly responsible for profits and losses and should have established the appropriate control systems for insuring their success.

Advantages of an "Active" Board of Directors

The primary question for the entrepreneur with respect to establishing and utilizing a board of directors is how active he or she wants the board to be in the decision-making

process (Ford, 1992). Two factors ultimately determine the answer: 1) the degree to which the entrepreneur possesses the skills and experience required to successfully manage the venture, and 2) how much control he or she is willing to relinquish over the decision-making process (Ford, 1992; Daily and Dalton, 1992). There are several ways in which boards have been shown to benefit their businesses, namely networking, providing access to critical resources, formulating business strategies, establishing governance policy, conducting independent assessments, providing specialized expertise, overseeing change and innovation, and managing in crisis situations (Moskowitz, 1990; Mace, 1971; Castaldi and Wortman, 1984; Osborne, 1994; Borch and Huse, 1993).

However, each phase of the startup process involves a unique set of issues. Thus, like the role of the lead entrepreneur, the role of a board should change as the venture progresses in startup. As we review the primary issues in each phase below, we also explore how a working board, as portrayed in the research literature, could benefit the entrepreneurial decision-making required at that point in the process.

Pre-Entry Issues

Boards are rarely used at the pre-entry stage of the startup process (Ford, 1992). However, given the types of issues entrepreneurs are challenged with at this stage, assembling an active board prior to market entry might be very beneficial. There are five major issues that entrepreneurs and their management teams must avoid when planning for a new venture (Naffsinger and Kuratko, 1991). The first issue is establishing a set of realistic goals for the organization. There are two concerns with objectives: 1) they must be specific and set according to an appropriate time table, and 2) they must be realistic. An active board can assist in setting realistic objectives if the experiences of its members (inside or outside the firm) help to round out the experiences of the lead entrepreneur and the management team. In its role as overseer, a board can also hold the entrepreneurial team accountable for achieving any pre-entry milestones, like developing prototypes, accumulating resources, and writing the business plan.

A second concern during pre-entry is the failure to anticipate potential problems (Naffsinger and Kuratko, 1991). A key to overcoming this issue is establishing a set of contingency plans. Contingency plans force the decision maker(s) to identify the weaknesses inherent in the original plan and to formulate alternative strategies for overcoming obstacles that arise. Once again, an active board could be instrumental in assisting the management team in developing such plans and in holding the lead entrepreneur accountable to see that the company was ready to implement the contingency plans if needed.

A third pre-entry issue is the tendency to lose commitment to the new venture (Naffsinger and Kuratko, 1991). Because of the difficulty many entrepreneurs experience when starting a new venture, many lose interest along the way or otherwise reach a point where they are no longer motivated to pursue the idea. Indications of a problem in this area are excessive procrastination on major issues, failure to invest personally in the new

venture, and missed opportunities (Naffsinger and Kuratko, 1991). An active board could help to see that the entrepreneur stays personally attached to the proposed business. An active board could also assist the entrepreneur overcome the common hurdles which often lead to a loss of commitment, including gaining access to key resources, securing participation of key personnel, understanding complex issues in technology, and researching the market.

The fourth major concern during the pre-entry phase of startup is the lead entrepreneur's lack of proven experience (Naffsinger and Kuratko, 1991). A board can indirectly work towards a solution to this issue by assisting the entrepreneur in recognizing key weaknesses in industry, startup or management experience and securing key managers to round out the experiences of the management team. More directly, a working board might provide additional skills such as long-range planning, environmental scanning, strategy development and implementation, and control. In addition, while a board should have little direct involvement in making day-to-day decisions, a board could effectively structure how day-to-day decisions get made, thereby insuring that most major issues are covered with experienced oversight.

Finally, the lack of a well defined market niche is also a major issue during pre-entry (Naffsinger and Kuratko, 1991). Ventures are often started with limited market niches and no real uniqueness to their product/service offering. A board whose members are knowledgeable about the particular market will be able to assist the entrepreneur in identifying the key success factors in the market and designing how to best serve the customer needs. The key at this stage is to insure that a specific market segment is targeted and that the product is appropriately designed to satisfy the unique needs of that segment. The ability of a working board to assist in this area depends to a large degree on whether its members possess a solid working knowledge of the industry. Thus, it is crucial that the entrepreneur hand select his or her board members during pre-entry so they can be assured that there is adequate knowledge of the market.

Market Entry Issues

Kuratko and Hodgetts (1995) identify five critical factors that must be carefully managed during market entry: 1) the relative uniqueness of the venture; 2) the availability of product; 3) the availability of customers; 4) the relative size of the investment; and 5) the expected rate of growth in sales and profits. The key to success in market entry is to "manage" the entry process so as to balance the resource requirements in each of these areas with the skills and resources of the young organization. Three of the factors - the uniqueness of the product/service offering, the availability of customers, and the availability of product - are closely linked to the day-to-day operations of the business. As such, management is not likely to involve its board of directors with such issues. The other two issues - the size of investment and growth in sales and profits - are more closely linked to the firm's strategic plans. Active boards should be heavily involved in the strategic (i.e., long-range) planning efforts of their young organizations (Ford, 1992).

The size of the startup investment is a critical issue to all new ventures. When the amount of capital required is relatively large, the ability to acquire the capital is limited, and the window of opportunity is short, a working board can be an effective asset for the new venture. The members of the board themselves might serve as a source for startup funds, or they may utilize their networking abilities to tap additional sources of funds. At the very least, their involvement in the development of the market entry plan lends credibility to the plan and creates the best opportunity for raising the necessary capital at the least cost.

The projected rate of growth in sales and profits is also of critical importance to the new venture. This factor, more than all others, illustrates how a venture can benefit from the input and oversight of an active board. An entrepreneur who does not project increasing sales and profits for his or her venture will face few challenges beyond their abilities. Therefore, they will have only minimal needs for outside resources and little need for expert advise. Otherwise referred to as "lifestyle" businesses, such entrepreneurs are commonly looking for independence, autonomy in their decision making and control. As such, they are least likely to need or desire the input of an active board of directors.

In growth-oriented ventures, however, the entrepreneur makes projections which stretch the firm beyond its present capabilities. Their plans typically call for access to large amounts of capital, increasing numbers of qualified managers, and lots of expert counsel and access to critical resources as the business grows. While these entrepreneurs also desire independence and control, their primary focus is on building wealth via the growth of the venture. As such, they are the most likely to need and desire the input of an active board of directors. Active directors of these types of firms assist in setting growth objectives, designing strategies to achieve those objectives, and accessing the resources required to see the strategies effectively implemented. Growth oriented firms also benefit from their board's relatively close interaction with the entrepreneurial team and their task of holding the entrepreneurial team accountable for achieving specific milestones.

Early Growth Issues

The goal of this phase of the startup process is to stabilize operations so that management can shift its focus away from market entry issues and begin to develop a more long-term perspective for the young venture. Though marketing and financial issues have dominated the entrepreneurial team's attention to this point, they now begin to consider growth issues and the need to reformulate their vision for the future. During this period, the entrepreneur is focused on 1) preparing for growth, 2) enhancing the company's perceptions of opportunity, and 3) establishing innovation as part of the company's overall strategy (Osborne, 1994).

Preparing for growth involves tasks similar to those in the pre-entry and market entry stages of startup. The firm begins to plan for its future based on the solid foundation management has established to this point. In addition to stabilizing the organizational structure, a great deal of the preparation for growth involves increasing the "opportunity

mindset" of key managers and declaring innovation as a basic building block for the future. Enhancing an organization's perceptions of opportunity requires a sound knowledge about what market opportunities exist and a support for pursuing those which are consistent with management's intentions for the firm. Members of the board who are experienced in preparing young ventures for growth could provide great insight to the entrepreneurial team at this stage of the startup process. In addition, the future of the new venture will depend to a large degree on the entrepreneur's ability to establish innovation as a cornerstone of its competitive strategy. Members of the board who are experienced in the core technology of the company's products will also be beneficial to the efforts of the entrepreneurial team to redirect strategic focus on innovation.

Establishing an Active Board at Startup

A recent survey revealed that of the nations fastest growing small companies who where "very likely" to go public in the near future, almost one third had not established a formal board of directors who met on a regular basis.(Heller, 1995; Daily and Dalton, 1993). However, several other studies have shown that a board of directors provides a useful tool when striving for survival and growth in entrepreneurial ventures. Ford (1992) identified the following ways an active board can be effective during startup:

1) setting overall company goals and developing plans for reaching those goals;
2) assessing the performance of the organization as a whole, as well as the performance of the entrepreneur and other senior managers;
3) taking appropriate corrective action to ensure that goals are met and that an effective organization is established;
4) establishing and evaluating corporate policies and procedures;
5) overseeing major organizational transitions (e.g., startup to growth);
6) accessing critical resources needed for successful startup (e.g.; people, capital, equipment, technology, etc.); and
7) periodic independent audits of management.

Due to the nature of the process and the high degree of uncertainty surrounding many of the decisions that must be made, the key to establishing an effective board for the startup of a new venture is to look for experience within the board members that the entrepreneurial team lacks. This, more often than not, means going outside the firm for specialized expertise. The advantages to having outside directors include: 1) added credibility for the firm; 2) assistance with making major management decisions; 3) access to additional management expertise that is not otherwise available; 4) an unbiased outlook on the future of the company; and 5) a fresh perspective on many issues (Daily and Dalton, 1992; Lauenstein, 1984; Nelton, 1985; Aronoff and Ward, 1992). Studies have also linked the presence of outside directors on the board with superior performance among young entrepreneurial ventures (Daily and Dalton, 1993).

The board should be composed of no more than five directors, with at least three being from outside the organization (Ford, 1992). The chosen outside directors should be experienced in all aspects of the new venture, including the startup process, the industry,

the product technology and the specific target market. When recruiting directors, it is important to be realistic about the skills required and the level of commitment expected. Prospects should be informed of the specific issues for which their expertise is being sought so they can factor that into their decision to join.

Implications

This paper has explored ways in which an active board of directors could benefit a young entrepreneurial company during startup. The benefits of a board depend on at what phase of startup they are used. However, this paper has shown ways in which a board can be effectively utilized at all phases of startup. The implications of the ideas presented in this paper for practitioners are clear - a more effective use of an active board of directors during startup can influence the future success of young entrepreneurial companies. However, the extent to which the board is utilized will depend heavily on the nature of the opportunity being pursued and the willingness of the lead entrepreneur(s) to relinquish control. This paper has shown that the need or desire to maintain control on the part of the lead entrepreneur will vary from phase to phase in the startup process, but an inability to share responsibility will ultimately stifle the growth of the new venture. Many of the ideas presented here are conceptually well founded in the research literature on the role of boards of directors in entrepreneurial companies.

The implications of this paper for scholars however, may not be as clear. Though the literature has aptly explored the role of a board in more established firms, it has failed to consider what that role might look like as organizations develop, particularly at the earliest stages. There could be a simple methodological issue leading to the lack of research on the role of boards at startup - very few startup firms establish active boards prior to market entry. This makes obtaining a representative sample difficult. What boards are established are usually “token” boards assembled to meet state incorporation requirements (Ford, 1992). This fact should strike both scholars and practitioners as odd, for at no other time in a young venture’s life are the risks so high, the complexities so vast, and the procedures so uncertain. In characterizing the startup process, this paper intended to lead scholars to areas of fruitful empirical research which will have real and lasting implications for future entrepreneurs. Such research could explore why so few entrepreneurs establish their boards prior to startup; to what extent and why the boards which are established are not involved extensively in the planning of the new venture; how and to what extent board composition influences the success of new venture creation; and what the implications are for the role of boards in startups as future legislation increases the extent to which a board member can be held liable for the firm’s actions.

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