Operating in disguise: Perception overrides reality

A study investigating venture capital firms' relationships to their portfolio companies in regard to control and innovation

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Master Thesis

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Operating in disguise: Perception overrides reality – A study investigating venture capital firms' relationship to their portfolio companies in regard to control and innovation

Abstract:

This paper adds to the previous research on Management control systems (MCS) in venture capital (VC) firms. By conducting 15 interviews with 12 VC firms in a cross-sectional study, the paper adds to the limited research of MCS in a VC setting and further explores how VC firms can use MCS to balance the tension between control and innovation relating to their portfolio companies. The theoretical framework takes its starting point in Bedford & Ditillo (2021) and adds the element of perceived interference, in order to make the framework more suitable to a VC setting. The paper finds that innovation is crucial for VC firms and that innovation is tied to the individuals and their capabilities, rather than technological assets. Secondly, the paper finds that it is not the specific control activity or form that decides the level of utilisation and if innovation is hindered, but rather if the control activity is perceived as interfering with day-to-day operations. Lastly, the paper adds to the research domain by highlighting that social and contractual controls are the two most important control forms as they mostly are naturally non-interfering, or if not can be disguised to be perceived as such.

Keywords:

Venture capital, management control systems, innovation, perceived interference, founder-friendly

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1. Introduction

"We know that most of our investments probably will fail but once in a while we hit the jackpot. But a prerequisite of hitting the jackpot is to give the entrepreneur freedom to create his own future for the company, that is what made us invest in the first place and if we do not see this potential anymore in a founder, we have clearly made a mistake".
– Partner, Dahlia Capital

The history of venture capital (VC) can be traced back to 1946, when a group of university professors and local business leaders founded American Research and Development. The company aimed to make high-risk investments in emerging companies which were based on technology developed for the second world war (Gompers & Lerner, 2001). In other words, the firm aimed to find disruptive companies with the possibility to change the world, due to technological advancements. This type of methodology has remained over the years, although it took around 50 years before substantial commitments to the VC industry really took off in the late 90s when the sector exploded, much due to the technological bubble (Gompers & Lerner, 2001). In later years, the VC industry has emerged to become a crucial player to the financial markets and the economy overall. The last decades of rapid technological advancements have disrupted brick-and-mortar industries and now technology, in some form, is present in almost every successful company. However, evaluating companies with a high degree of its value attributing to a technological edge is often hard, compared to companies which mostly can be assessed by looking at hard financial numbers. This means financing, in general but also with acceptable terms, can be tough to acquire for these types of companies (Hellman & Puri, 2000). Because of this, the VC industry serves as an important function to the financial market. It is particularly interesting to research the VC sector in the spring of 2022 given the current investment climate. The Swedish stock index OXS30 is close to all-time-high, meanwhile fund inflows for European VC have exploded and investments just broke the EUR 100bn mark at an all-time-high, corresponding to a YoY increase of >100% (European Venture Report - Pitchbook, 2022).

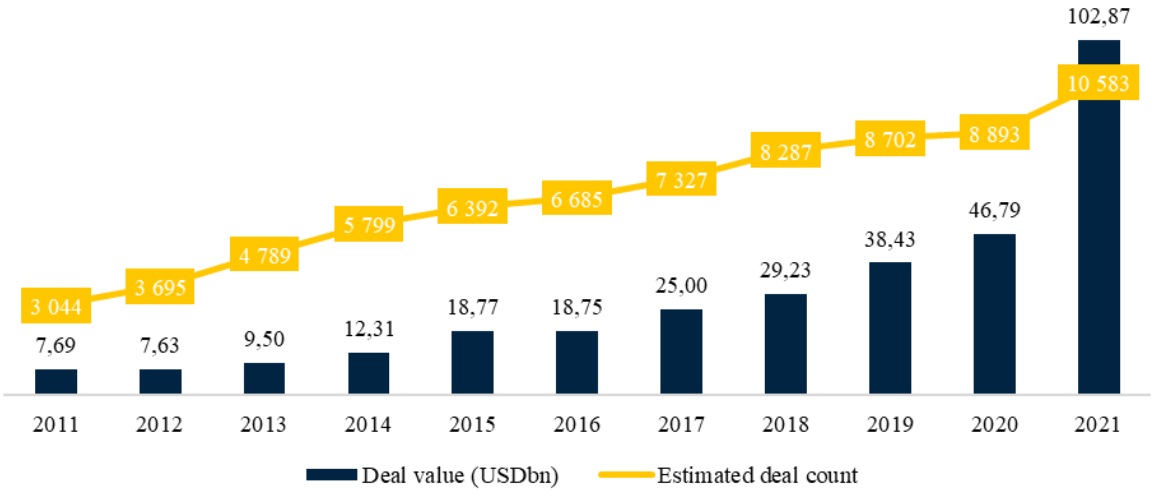

Figure 1: European deal value and estimated deal count, 2011-2021

Given the increased inflow of capital to VC funds, VC companies are liquid and ready to invest. They are prepared to take on risk and make a bet, in order to possibly find the next Uber or Spotify. However, less obvious is how VC firms work with their new investments in order to align ownership goals and make sure the right strategy is followed. There is a gap in previous research concerning how VC firms work with management control systems (MCS) to achieve control over their portfolio companies. A MCS is defined as the overall control system of an organisation encompassing all control forms and activities. Bedford & Ditillo (2021) divided the MCS into four different control forms, and each of these control forms consists of different specific control activities. A few studies, such as Bedford & Ditillo (2021) and Dello Sbarba et al. (2020), have analysed how private equity (PE) firms as a broad category utilise MCS, but their findings are not limited to VC companies. PE companies and VC firms are similar in some ways, both are financially oriented with the main objective to make returns for their partners. However, their value creation model differs substantially, since PE does majority investments and pursues companies with stable cash flows and low cyclicality for instance (Blundell-Wignall, 2007; SVCA, 2022). In contrast, VC pursues risky ventures with innovative ideas. These companies typically are unprofitable at the investment stage, but have disruptive ideas which contribute to a high long-term potential to significantly expand the business. There is therefore a need to separate the two investment company categories, and get an understanding of how the VC industry reason regarding their utilisation of MCS. In order to do so, the paper's first research question is as following:

i) How do VC firms work with Management Control Systems in their portfolio companies?

On another note, there has been a long-standing debate of whether MCS constrains or enables innovation (see e.g., Davila, 2000; Davila & Wouters, 2004; Davila et al., 2009; Christner & Strömsten, 2015; Barros, 2019; Barros, 2021). The domain has shifted from previously seeing the relationship between control and innovation as distinctively negative, to seeing the relationship as positive, and more nuanced, where an accounting-based MCS still is viewed as a constraint to innovation. The control innovation dilemma is particularly interesting in a venture capital setting. This, since VC firms naturally are extremely financially oriented (as all companies with investments as their main focus). Their success is determined by the accumulated sums of prior exits minus new acquisitions. Tangible, financial numbers are the masters of their universe. They want their portfolio companies to continuously increase sales and profitability. Meanwhile, they invest in emerging technological companies, whose long-term success is more attributable to its potential to innovate. Entrepreneurs in this organisational life-cycle stage rather see money as a tool to achieve their objective, which is to create a disruptive product or service that is better than existing alternatives. Of course, they often dream about making an exit and achieving financial freedom, but this cannot be a short-term focus. There should therefore be a tension between VC firms and its portfolio companies, since they in one way can be said to strive in different directions, where the founders want to innovate but the VC has a need to control what is happening with their invested money. VC firms therefore face a unique problem which potentially could be paradoxical; How to manage portfolio companies to encourage innovation, whilst

simultaneously being financially oriented which puts pressure on exercising control? Furthermore, since VC firms acquire minority stakes it adds an additional element of complexity, compared to private equity firms, who gain full control. Despite this, not much research has analysed this dilemma and the authors argue that there is a need to bridge the gap in the literature. This paper therefore aims to answer the research question:

ii) How do VC firms use MCS to manage the tension between control and innovation relating to their portfolio companies?

In order to answer the paper's research questions, a qualitative multiple case study consisting of 15 interviews with 12 different firms have been conducted. The interviews followed a semi-structured approach, meaning that questions are based on a few predetermined questions but that the discussion goes in a certain direction depending on the interviewee's response. The results from the interviews are presented according to the Bedford & Ditillo (2021) framework, which classifies control activities on the basis of control form.

Our paper has three main findings. Firstly, we find that innovation is crucial for VC firms when evaluating new investments. In addition, innovation in a VC setting is viewed to be closely tied to the individuals and their capabilities, rather than technological assets. This creates a need to respect entrepreneurial freedom and to be perceived as founder friendly, hence influencing how VC firms work with their portfolio companies to a large extent. Secondly, the paper finds that it is not the specific control activity or form that decides the level of utilisation and if innovation is hindered, but rather if the control activity is perceived as interfering with day-to-day operations. VC firms can manage this task by operating in disguise, i.e., an excessive utilisation of control activities that are perceived as non-interfering, even though they could be interfering. In a best-case scenario the founders do not even notice that they are being controlled. As a consequence, we develop the framework of Bedford & Ditillo (2021) in order to portray a relevant picture of a MCS in a VC setting. Lastly, our findings regarding how control forms interplay are partly in line with previous literature, suggesting *social* and *contractual controls* to be present and important (Bedford & Ditillo, 2021; Dello Sbarba et. al, 2020). However, we nuance their findings by further elaborating on why they are important specifically in a VC setting. Furthermore, the paper investigates the topic from a principal-agent perspective and hopefully can give VC firms a better understanding of how they operate and assert control on their portfolio companies, without the portfolio company losing innovation capacity. In addition, our paper provides an understanding for entrepreneurs on how VC firms operate, what to look out for, and the potential loss of control caused by a VC-partnership.

The structure of the paper is outlined as follows: Chapter 2 introduces the theoretical foundation of the essay and outlines previous research within the two main research domains: control and innovation, and MCS in VC. In addition, the chapter outlines the theoretical framework and discusses identified research gaps. Chapter 3 specifies the study's methodology and research design. Chapter 4 presents the empirical analysis and Chapter 5 discusses the practical findings, limitations of the study and suggestions for further research.

2. Literature review

The paper's second chapter lays out existing research within innovation and MCS in a VC setting. Section 2.1 covers previous research regarding the relationship between control and innovation and how the domain has developed over time. Section 2.2 covers the existing, yet limited, previous research of MCS in a VC setting. Thereafter, section 2.3 describes the identified research gaps for which the paper aims to contribute. Finally, the paper's theoretical framework based on Bedford & Ditillo (2021) is introduced in section 2.4.

2.1 Relationship between control and innovation

Previous research about control and innovation has been conducted through an R&D lense in order to understand the relationship between the two. This is highly relevant for VC firms, given R&D departments' critical role for their portfolio companies' innovation and value-creation models. The early research domain of the management control systems (MCS) and product innovation had a pessimistic view of the relationship between the two. This domain of research mainly focused on accounting-based MCS e.g., financial metrics and budgets as a way of exercising control and put little emphasis on non-financial MCS. Rockness & Shields (1984), Brownell (1985), Birnberg (1988) and Abernethy & Brownell (1997) all found a negative relationship between accounting-based controls and innovation. The studies' methodology centred on a contingency approach where the relationship between accounting-based controls and product innovations is presented as a control/creativity dilemma (Christner & Strömsten, 2015).

Rockness & Shields (1984) investigated organisational control frameworks in R&D centres using the organisational framework developed by Ouchi (1979) and found that the importance of controls varied depending on the task transformation process (technological uncertainty) but was not affected by the measurability of outputs, task complexity or task dependence. The author argued that in an environment with low task transformation, i.e., high technological uncertainty, input control such as *social controls* were more important than accounting-based MCS. In these types of environments, accounting-based MCS was seen as detrimental to innovation. However, in a high task transformation setting (low uncertainty), accounting-based MCS seemed to work better. Brownell (1985) also focused on the R&D function, by studying a large electronics company and analysed the effect that the choices of control systems had on managerial performance. The authors found that a higher degree of participation by top managers in budget preparation is effective in an R&D department. This, since the collaborative approach yielded more value in the more complex environment. In a complex environment such as the R&D department, companies should therefore rely less on accounting-based MCS, supporting Rockness & Shields (1984) thoughts regarding low task transformation settings. Control systems take away time from other more value-added activities, and simultaneously the outputs are hard to quantify in accounting numbers and hence creates discrepancies. Abernethy & Brownell (1997) further examined the role of accounting and non-accounting controls in an R&D setting by expanding the research through

incorporating Perrow's model of technology which focuses on the two dimensions, task analysability and number of exceptions (Gibbs, 1970). The authors found that accounting-based control systems constrained innovation in a setting where input-output variables were hard to quantify, as the accounting controls could not be used effectively given the uncertainties. These findings are in contrast to Rockness & Shields (1984) who did not find any evidence that the input-output measurability dilemma affected innovation. However, the authors found a positive relationship between non-accounting-based controls such as personnel controls and innovation, in organisational settings, where uncertainty was high. These findings are in line with the findings of Rockness & Shields (1984) and Brownell (1985). In sum, the old literature domain focuses mainly on accounting-based MCS and suggests a negative relationship between control and innovation.

During the early 2000s, a new research domain developed that nuanced the previous view. In contrast to the previous dominant domain discussed earlier, which saw MCS as obstacles to innovation, the new domain saw the relationship between control and innovation as positive, or in some instances more complex. Part of the changed view can be explained by the refined definition of MCS where e.g., Davila (2000) took a broader approach of the definition of MCS, and focused mainly on non-accounting-based controls which he argued was more important than accounting-based controls. Furthermore, Davila (2000) expanded the definition of what constitutes a MCS in an organisation. The author examined the relationship between project uncertainty, product strategy and MCS with Galbraith's concept of uncertainty. The author found that R&D managers used MCS to reduce the uncertainty inherent when working with product development. In addition, the author found that the alignment between the design and the use of the MCS, was crucial for product development success, i.e., innovation. Davila & Wouters (2004) continued the research with the newly found perspective and examined accounting-based MCS, a focus in line with many of the previous authors. The authors found that by shifting away from traditional target costing models, e.g., hard budgets and traditional accounting-based MCS, the firms could focus more on its value-added R&D activities and hence they found a positive relationship between these new types of accounting-based MCS and innovation. Davila et al. (2009) deepened the analysis by looking at the adoption of MCS in a product development division, where innovation is critical to the division's success. The authors look at seven different management control techniques: project milestones, reports comparing actual progress to plan, budget for development projects, project selection process, product portfolio roadmap, product concept testing process, and project team composition guidelines. The authors find several different reasons for adoption e.g., legitimising the process and manager related reasons such as different backgrounds. Furthermore, the author finds that these reasons for adoption are related to the on-time dimension of product development performance and hence positively related to the innovation aspect.

Christner & Strömsten (2015) and Barros (2019) nuances the relationship between control and innovation, given the aforementioned shift in literature consensus towards a more positive attitude to MCS. Christner & Strömsten (2015) examined the role of an accounting-based

MCS in a biotech firm and found that the role of an accounting-based MCS shifts during the different development stages and that it can work both as enabling and constraining with regards to innovation. The authors further argue that different accounting calculations help forge the path for certain projects and can work both as an enabling and a constraining tool. Lastly the authors introduce the concept of calculative momentum to further understand the role that accounting plays. Barros (2019) examined the current literature on the relationship between MCS and innovation and described the evolution that eventually led to a consensus based on a more positive relationship between the two. Barros' explanation of the shift is that new research focuses more on the strategic aspect and less on efficiency and return, i.e., traditional accounting-based MCS, hence creating a more nuanced view of the relationship between control and innovation, in line with Christner & Strömsten (2015). In order to innovate, companies must use a multiplicity of controls and the tensions that will exist are only natural and part of the process. Barros (2021) deepened his research by investigating how Simon's four levers of control could be utilised to increase innovation in a company. The author suggests that all levers must play a part in enabling innovation. Diagnostic and boundary systems form the strategic direction for the innovation effort while it simultaneously reduces the uncertainty. The belief and interactive systems work as inspirational forces while they also contribute proactively. Barros (2021) resembles the process with driving a car where the inspirational forces are the accelerator and the more constraining forces, boundary, and diagnostic, are the steering wheels which helps it to reach the destination. The analogy demonstrates that the inspirational forces need some constraints in order to avoid losing its main objectives.

To summarise, it is clear that the view on the relationship between control and innovation has shifted and become more nuanced, compared to the early research. It is not clear-cut whether academic consensus is pointing towards a positive relationship between the two, or if it depends on the particular situation. Another interesting aspect is the new, more encompassing definition of MCS, including both accounting and non-accounting based MCS. Early researchers, e.g., Rockness & Shields (1984) had a determined view that the relationship between control and innovation was negative. However, the authors did find evidence that in environments with high uncertainties, *social controls* were important for innovation. Abernethy & Brownell (1997) had similar findings regarding the importance of personnel control. This brings out the questions whether the redefinition of MCS can solely explain why the research domain has shifted, or if the nature of an organisation has just become more complex as business has evolved. In addition, there still seems to be a consensus that there is a negative correlation between purely accounting-based MCS and innovation, i.e., controlling through strictly KPIs, budgets and results. This paper will dive deeper into MCS and its sub-components compared to much of the previous research which takes its starting point from the distinction of accounting or non-accounting-based control. In contrast, we investigate MCS in relation to control and innovation on the basis of perceived interference of specific control actions in order to cope with the complex universe of VC, and thereby nuances the academic domain. An interfering activity is defined as disturbing, affecting day-to-day operations, and taking away the founders' focus, whilst non-interfering activities creates no disturbances.

The next section will outline an overview of the current research domain of VC in relation to MCS.

2.2 Venture capital and management control

2.2.1 Overview of venture capital: Investing in innovating companies to get financial returns

Venture capital (VC) can be seen as one pillar to the broader term private equity (PE), which also involves growth capital, buyouts, and other alternative investments. A VC firm is a professional investment institution, referred to as the *general partner*, which raises capital from external investors such as institutional investors, wealthy individuals, and pension funds. These external investors are referred to as *limited partners* (Kaplan & Strömberg, 2009). The raised funds are thereafter gathered in funds which invest in emerging or young companies which are believed to have high growth potential. Time horizons on the funds are limited, with a lifespan depending on investor preferences and the VC firm's individual characteristics. However, a typical lifespan for a VC fund is normally around 10 years (Gompers & Lerner, 1999; Kandel et al., 2011).

VC firms often target firms with high scalability potential and an internationally viable business model. These types of firms are often based in the technology or life science sectors (SVCA, 2022). The VC industry therefore constitutes an important player in the financial markets, contributing to strength in the economy by enabling innovative firms to scale-up their development phase and thereby lowering time-to-market on their products or services (Hellman & Puri, 2000). Furthermore, VC firms typically do not obtain majority control, but instead act as a partner to the founders. In these ways, VC distinguishes itself from the traditional and perhaps more well-known subset in the context of PE, buyout funds. Buyout funds generally focus their investment activities on mature firms, often characterised by stable cash flows and non-cyclical business models which they take majority ownership in (Blundell-Wignall, 2007; SVCA, 2022). In addition, PE is not closely connected to innovation, which is central in VC. The driving forces and investment objectives behind VC and PE therefore differ, why it is important to separate the two subsets.

Prior to making an investment decision, VC firms thoroughly conduct a due diligence process on the founders and its business to understand it to the core. In conjunction with an investment, they use their financial expertise to structure it, including incentive schemes for founders (Garmaise, 1999, Kaplan and Stromberg, 1999 & 2009). When an investment is made, the VC firm supports the firm to succeed with its growth journey. VC firms are also keen to raise additional funds for their portfolio companies, and as a consequence they are incentivised to monitor their new investments in order to be able to provide certification for other external investors (James, 1987). After the investment objectives have been achieved, VC firms often take an active role when evaluating possible exit options, such as an IPO (Hellman and Puri, 2000).

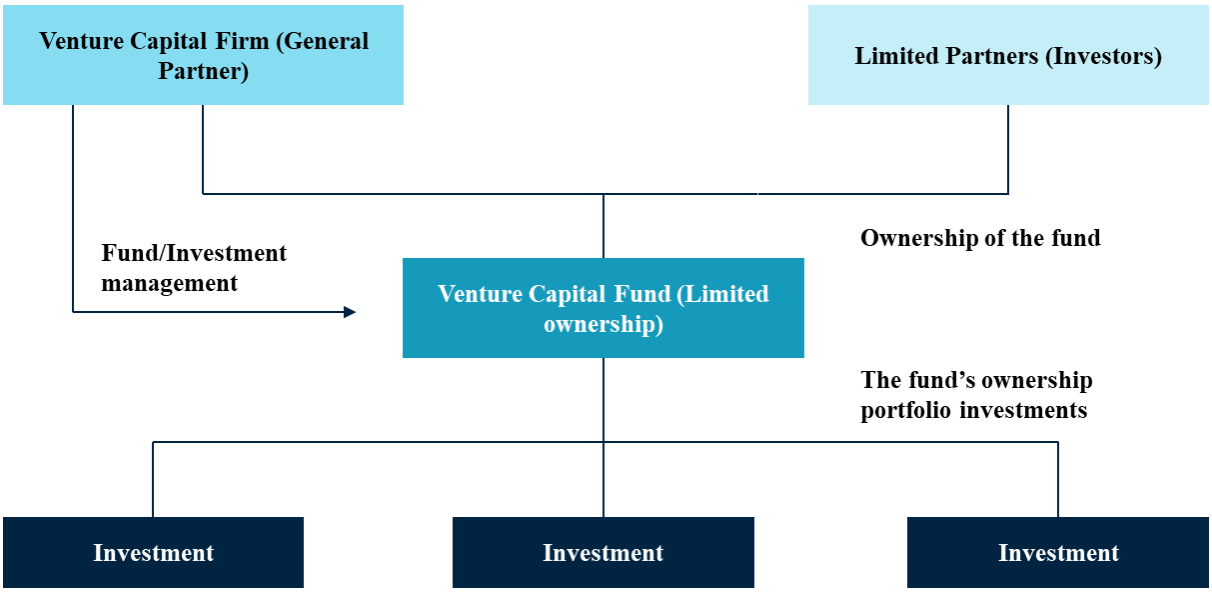

Figure 2: Structure of a VC firm

2.2.2 What venture capital firms bring to their portfolio companies

Since target companies for VC firms are often rather small, they often do not possess the same knowledge and resources as larger firms by nature. Consequently, the dynamics of the transaction differ. An entrepreneur, aside from cash, acquires valuable assets in conjunction with a VC entry, assets which can be leveraged for developing their firm's internal capabilities and managerial resources. This is because VCs usually are knowledgeable in technological advancements and market development in their niche, due to their experience but also desire to make well informed investment decisions to stay competitive (Hellman and Puri, 2000; Fenn et al., 1995). VC firms can therefore provide strategic advice, hard-to-reach insights, mentoring as well as business contacts which all can assist the company to grow their business. A potential VC investment therefore constitutes an important consideration for founders. It is therefore logical that some differences between start-ups can be explained by whether the firm is VC backed or not, and that VC firms have a positive effect on the development pace of a start-up and their market position (Hellman and Puri, 2000). In addition, a VC investment can be attractive from a financial standpoint since it can be troublesome for emerging companies without a financially proven business model to obtain financing in other ways since uncertainty levels are high. VC firms are used to these prerequisites, and can therefore sometimes offer more attractive financing solutions than from other sources (Hellman and Puri, 2000).

2.2.3 How venture capital firms use and value MCS

Previous research on MCS in a VC setting is very limited, however a few studies have touched upon the topic and contributed to different aspects. The application of MCS in firms can be explained by the organisational life-cycle. Naturally, the MCS develops and becomes more sophisticated as the company grows (Davila et al., 2003; Silvola, 2008). As VC firms

invest in early-stage companies, this indicates less application of MCS in VCs portfolio companies, and thus partly explains why the research within the field is limited. However, the academic consensus is that VC investments have a positive impact on the MCS development (Meyssonnier, 2015; Davila et al., 2003; Granlund & Taipaleenmaki, 2005). On the other hand, firms that VC invest in have higher growth than average, for different reasons (such as funding resources). It can therefore be argued that the findings on VC firms' positive impact on MCS development is biased, since it is hard to determine whether the actual VC engagement is the cause of strengthened MCS, or if it is just that MCS develops quicker because the portfolio companies outgrow the market (Davila et al. 2003). Hence, VC firms' contribution to their portfolio companies on developing their MCS is unclear. However, due to their experience and knowledge from previous investments, VC should logically identify if there is a need to develop the MCS system when entering an investment, and push the founders towards that direction. The MCS will also naturally develop with the VC investment since the new presence of external stakeholders will put pressure on developing the system. This, since VC firms demand access to information in order to monitor the firm in order to track their investment, which may require the firm to develop different types of control systems (Davila et al, 2003).

Another perspective on MCS importance for VC firms is by looking through a pure financial lense. Although angel investors enter the investments in a prior funding round to VC firms, they generally do not influence the firms to develop their MCS as angel investors usually do not get involved operationally (Meyssonnier, 2015). This is in line with Granlund & Taipaleenmaki (2005), which confirms that VC firms develop the MCS faster, but also found that pre-seed angel backed firms often do not have developed MCSs. This is interesting, since higher MCS development has been found to impact company value positively prior to a financing round including VC, especially for high-growth companies in highly competitive industries. In addition, an alignment of the strategic positioning with the MCS has also been found to positively impact the company value (Davila et al., 2015). Angel investors and companies seeking VC investments should therefore be incentivised to emphasise the development of MCS prior to a seeding round with VC investors. The findings that VC firms are prepared to pay a premium for firms with a well-developed MCS strengthens the case of its importance. To summarise, research on MCS in a VC setting is limited but the academic consensus is that VC investments accelerate the development of MCS. However, it is hard to determine whether it is the actual VC entry, or just increased company growth which causes this acceleration. What is clear, however, is that VC firms value an existing and sound MCS when making an investment decision.

2.3 Identified research gaps

2.3.1 How venture capital firms use MCS

Despite a worldwide growing capital inflow to VC firms, there are few studies that have researched how VC firms use MCS with regards to its portfolio companies. There is some research related to MCS in early phase firms and start-ups (see e.g., Meyssonnier, 2015; Davila et.al, 2003; Granlund & Taipaleenmaki, 2005), but according to the authors' knowledge none directly focuses on how VC firms utilise MCS in its portfolio companies. There is, however, substantially more research related to PE firms and MCS, and in some instances VC firms are classified as a type of PE firm, creating ambiguity in the literature to what actually constitutes VC literature. This paper aims to clearly distinguish VC from the general PE research, due to its differences such as ownership style and investment focus (see section 2.2.1). As discussed in section 2.2.1, VC and PE investment philosophy differ substantially, so it is reasonable to assume that the forces of the different control forms are unequal. Because of this, the authors' ambition is to contribute to existing research by exploring how VC firms work with MCS, and in particular try to understand which control forms are potentially more important than others and how they interplay.

2.3.2 How venture capital firms balance the trade-off between control and innovation

VC firms need their portfolio companies to be innovative and fast-growing, and simultaneously VC firms strive to achieve control over their portfolio companies, given their nature of being extremely financially oriented as discussed throughout the paper. Hence, it creates a potential tension between the control exercised by the VC company through its use of MCS and the innovation in its portfolio companies. This becomes especially important since the majority of VC portfolio companies are minority owned, which decreases the power that can be exercised by the VC company since they do not possess the majority of voting rights. There is a substantial domain of literature regarding the relationship between MCS and innovation. Early literature, (see e.g., Rockness & Shields, 1984; Brownell, 1985; Birnberg, 1988; Abernethy & Brownell, 1997), defined MCS as an accounting-based mechanism focused on financial control and found a negative relationship between MCS and innovation. Later researchers (see e.g., Davila, 2000; Davila & Wouters, 2004; Davila et al., 2009; Christner & Strömsten, 2015; Barros, 2019; Barros, 2021) took a broader and more encompassing definition of MCS, and included non-accounting-based controls and found that MCS did not hinder but instead fostered innovation in some instances. The current domain views the relationship between MCS and innovation mainly as positive, although some researchers argue that the relationship is complex and differs depending on the situation. However, there seems to be a collective view that traditional accounting-based MCS, i.e., budgets and KPIs, have a negative view on innovation. However, there is no research in this field related to VC. This paper therefore aims to add to the research domain by analysing the relationship between MCS and innovation in a VC setting and how VC companies balance the potential tensions between control and innovation.

2.4 Theoretical framework

2.4.1 Defining a Management Control System in a venture capital setting

In order to analyse MCS in the context of VC, the Bedford & Ditillo (2021) framework is applied. As continuously discussed during this paper, VC is often considered a subset to PE in the academic literature, so it makes sense to utilise the framework in a VC setting (Kaplan & Strömberg, 2009). In addition, despite the discussed differences between PE and VC, many similarities exist such as both being extremely financially oriented. According to the authors' belief, Bedford & Ditillo's (2021) contextual four-category control model can therefore be applied in order to produce a relevant picture of MCS in a VC setting, in order to answer the paper's first research question. Bedford & Ditillo (2021) studied management control in the PE industry and argued that there are only a few studies which previously have researched how PE firms exercise control over their portfolio companies (Bedford & Ditillo, 2013; Dello Sbarba et al., 2020). Contractual agreements are a vital part of the relationship between PE and its portfolio companies; previous research had therefore mostly covered the subject from an agency perspective, focusing on *contractual controls*. However, Bedford & Ditillo (2021) argued that it is generally acknowledged that management control in a PE setting extends outside of *contractual control*, why they incorporated Dekker (2004) and Merchant & Van Der Stedes (2017) classification of management accounting techniques to include *results controls*, *behaviour controls* and *social controls* to set up a framework. The control forms were categorised into four fields; *contractual*, *results*, *social and behavioural control* to create a framework suitable for a comprehensive analysis of management control in a PE setting. Furthermore, Bedford & Ditillo (2021) argue that the importance of these controls differs depending on the ownership stake (minority vs majority) and perceived cognitive style of how the portfolio company is led (entrepreneurial vs managerial). In addition, Dello Sbarba et al. (2020) found that *social* and *contractual* controls were present regardless of the perceived cognitive style in minority owned firms, which is the ownership structure for most VC investments. This signalises that *social* and *contractual* control will be important control forms to research in order to get a comprehensive view of the control forms in a VC setting.

Contractual control can be explained as legally binding agreements that detail rights and obligations by each party (Poppo & Zenger, 2002). This form of control is important for VC as it is used extensively in order to align ownership goals due to the potential moral hazard problems given minority stakes investments (Gompers, 1995). *Contractual controls* are commonly adapted already with the initial investment, namely the structure of the transaction. Convertible securities, syndication and incremental financing are used in most VC investments. Syndication and especially incremental financing (i.e., VC initially invests a smaller amount but takes on a contractual agreement to make larger pay-outs if certain targets or goals are met), are two alternatives in order to mitigate moral hazard issues and ensure goal alignment with the founders, preceding the transaction (Gompers, 1995). Incremental financing and earn-out schemes are clear examples of how founders are restricted from making any unwanted moves such as being less interested in the company's advancement,

after receiving a large paycheck. Because of this, *contractual controls* are important in a VC setting since they directly limit the potential agency costs. In a VC setting, *contractual controls* are also linked with *results control,* since the direction of *results control,* for example goal setting, can be affected by how *contractual control* forms are stated. In addition, goal setting is also important in a VC setting given the often ambitious expansion plans. Goal setting has been proven to be more emphasised by VC backed firms than those without VC funding, especially for firms in a later stage of the organisational life-cycle. This, since VC firms have the aim to increase company value prior to their exit (Silvola, 2008).

In addition to goal setting, *results control* concerns monitoring KPIs, budget, strategy and incentive schemes for the portfolio company's personnel and founders (Bedford & Ditillo, 2021). Graebner and Eisenhardt (2004) conducted a multiple-case study which analysed 12 technology-based ventures, 10 of which were backed by angel investors or VC. The study suggests that VC firms tend to be rather relaxed about these types of control measures and instead seek a more strategic role, looking at the big picture whilst helping to set the company in the right direction through a master plan (Graebner and Eisenhardt, 2004). Monitoring and ratification of specific actions are therefore less common. VC firms rather saw their main roles as giving strategic advice and enabling access to funding and other connections (Graebner and Eisenhardt, 2004). Partnering with portfolio companies and being supportive, by offering advice on strategic direction and setting up the right performance management system is important for VC firms since the companies are young and often lack formalised structures (Davila et al., 2005; Granlund & Taipaleenmaki, 2005). As discussed in section 2.2.3, VC firms are prepared to pay a premium when they first invest in firms with an established MCS. Since these firms generally are at a very early stage in the organisational life-cycle, it is probable that their *results control system* constitutes a major part of their MCS. Interestingly however, as discussed above, VC firms do not seem to put emphasis into micromanaging their portfolio companies through monitoring. These findings together therefore indicate a laissez-faire approach where whilst the VC firms value that the target company has set up adequate tools for monitoring, they are themselves not interested in taking part in such activities. This is particularly interesting since VC firms are financially oriented which implies that *results control* should be favoured. In essence, this means that the VC firms need to trust the founders and management teams to conduct the *results control* themselves in an adequate way. In this way, *social control* is indicated to be important in a VC setting.

Social control includes e.g., social networks in the organisations, interactions, trust, joint decision making, problem solving and risk taking. They are said to strengthen collaboration between a VC firm and its portfolio company through creating shared norms, building trust, and thereby reducing information asymmetry (Dekker, 2004). According to Decker (2004), trust is the building block for the *social control* system and the most important one. The author differentiates between calculus-based trust, relational trust and institution based trust. Calculus-based trust is based on utilitarian considerations and is based on reliable information. Relational trust is based on interactions between the trust and the trustee and

takes time to build up. Institution-based trust is based on the organisations and aspects such as legality and its compliance with societal norms. Since VC firms tend to take on a supportive role with little emphasis on monitoring activities, *social controls* become of greater importance since trust to the portfolio companies' managers must be established. Both relational and institution-based trust therefore become two important factors for VC firms to foster a sound relationship with the portfolio companies. Dello Sbarba et al. (2020) further supports the importance of *social controls* in minority owned firms, which VC firms mostly are. On another note, it is unclear to what extent VC firms bring norms to their portfolio companies and if (or how) they aim to change norms and social structures.

Behavioural controls achieve control through putting boundaries and constraints on the VC firm's portfolio companies and its personnel. These include but are not limited to rules, procedures, authority structures (Dekker, 2004). In this way, *behavioural controls* seek to form unity and conformity within the group. In addition, Dekker (2004) argues that since organisations are often subject to goal congruence and performance ambiguity, behaviour controls play a key part in achieving the desired organisational behaviour. There is limited research targeting *behavioural controls* in a VC setting. This form of control therefore constitutes an important field to investigate when gathering empirical data for this paper, in order to contribute to the research domain.

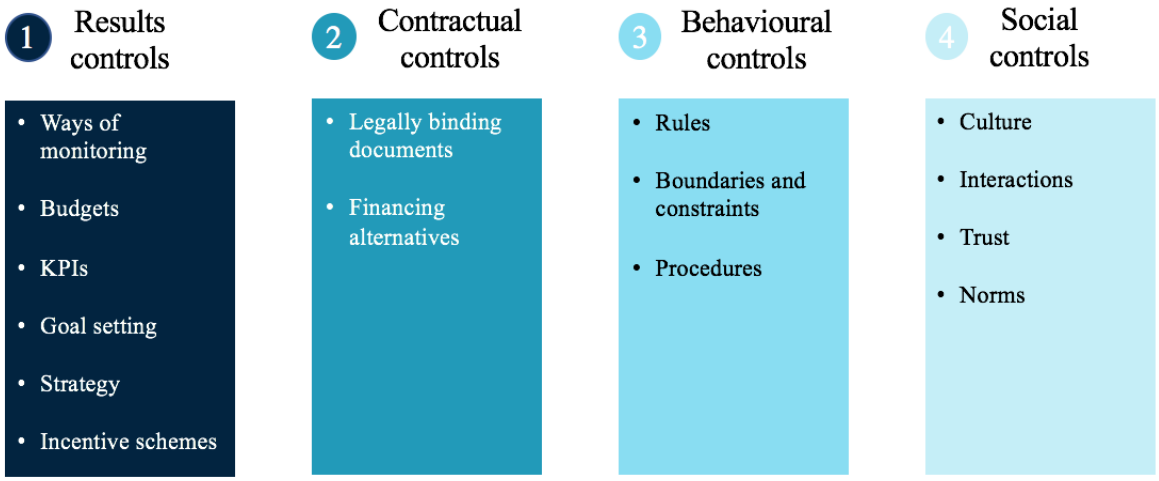

Figure 3: Framework: Bedford & Ditillo (2021)

2.4.2 Bedford & Ditillos (2021) framework in an innovation vs control context

As discussed in section 2.1, the view of the relationship between control and innovation has shifted from being viewed as negative to being seen as a more positive one. Some recent studies (Christner & Strömsten, 2015; Barros, 2019) nuances the results and argues that MCS can be both enabling and constraining, depending on how they are used. Part of the shift can be explained by a redefinition of the concept MCS, which now includes a wider scope of non-accounting-based MCS, compared to historically when it was entirely focused on accounting-based MCS.

In order to answer the second research question, we will analyse how VC firms balance the tension between controlling their portfolio companies and enabling them to be innovative, which is critical, through the lens of Bedford & Ditillo (2021). Bedford & Ditillos (2021) contextual framework is not directly linked to the control and innovation dilemma and the four types of control cannot clearly be divided into control and innovation buckets. However, the authors argue that this makes the model dynamic and adaptable and hence a great toolbox to study the innovation vs control phenomenon. C*ontractual controls* can be argued to possibly limit innovation, since the entrepreneurs' freedom is restricted in order to decrease agency costs. On the other hand, *contractual controls* could also contribute to innovation since the entrepreneurs are assisted to set a strategic path to follow, which means they can focus on what made their firm an interesting investment target in the first place, innovating thoughts. Hence the effect of *contractual controls* on innovation is ambivalent. Much of the previous literature regarding control and innovation has focused on what Bedford & Ditillo (2021) define as *results control*. The consensus regarding its effect on innovation is that it hinders innovation, as no researcher has been able to rebut the findings of the old domain. In one way this is natural as the focus lies on control, monitoring and keeping operations in-line, hence working against innovation. *Results control* constitutes an interesting aspect with regards to VC firms. On the one hand, VC firms have a control issue. Since they do not buy majority stakes, they do not have full control over the portfolio company. In addition, since VC firms by nature are financially oriented, there must be a strong pressure towards their portfolio companies to perform well. This, since the VC firms' partners demand a solid return. Hence there should be a strong need to measure the portfolio companies, and one way of measuring would be through *results control*. However, given the nature of the firms that VC invests in, e.g., high growth and technology, there is simultaneously a strong need for the portfolio companies to be innovative. Given that previous research implies that *results control* hinder innovation, it provides a natural tension that must be managed. *Social controls'* effect on innovation in a VC setting is hard to evaluate. Fostering innovation is core in a VC firm given their experience and objectives, but if applying *social controls* such as adapting norms, culture etc. enables innovation or restricts it by taking away portfolio company's cultural DNA is questionable. The same way of reasoning applies to *behavioural controls*, where the effects of innovation are hard to evaluate. To conclude, there are four types of control that VC firms use to control the portfolio companies, whilst simultaneously there is a need to enable the portfolio companies to be innovative; a tension is therefore present.

3. Method

The paper's third chapter outlines the research methodology that the study has adopted. Firstly, section 3.1 gives an overview of the research design while section 3.1.1 motivates the selection of a qualitative research approach. Thereafter, section 3.2 describes the empirical data collection process and how that process evolved over time while section 3.3 describes the analytical process adopted. Finally, section 3.4 outlines data quality issues and what coping methods have been used.

3.1 Research design

3.1.1 Qualitative multiple case study

In order to answer the papers' research questions, a qualitative study was chosen rather than a quantitative. This choice refers to the advantages of the study form, i.e., its ability to cover breadth and complexity over a research phenomenon which quantitative studies cannot due to their statistical approaches (Lillis & Mundy, 2005). A majority of the control forms in the Bedford & Ditillo (2021) framework involves non numerical aspects, which are hard to quantify. The same goes for the innovation vs control discussion, which is an intangible topic with a need to explore through gathering information directly from relevant sources (interviewees). Furthermore, since the paper's research domain is rather unexplored and complex, a qualitative study is to be preferred since it allows the author's to continuously develop the paper's narrative and spirit depending on the analysability and applicability of the empirical results attributable to the extensive interviews (Lillis & Mundy, 2005). In addition, we use an interpretive research approach which is characterised by researching through the lense of organisational, psychological, and societal context. There is a great need to deeply understand the interviewees' subjective opinions and perspectives, since these can differ between each other (Lukka & Modell, 2017).

Since the field of MCS in a VC setting is rather unexplored, the authors chose to conduct a multiple case study. This, since there is a need to gain insight from a larger population of VC firms, in order to understand the collective view of the industry's thought process and methodology concerning their investments in regard to MCS and the potential innovation vs. control dilemma. Obviously, just like for firms in other industries, there is a need for VC firms to differentiate themselves in order to stay competitive. The way of dealing with MCS and its different components according to the Bedford & Ditillo (2021) framework, therefore differs depending on VC firm characteristics. For example, characteristics such as preferred investing stage and size is likely to impact how the VC firm values, prioritises and utilises the control forms (see section 4.3). Bedford & Ditillo (2021) also highlights that the importance of the components in their framework differ depending on ownership stake and perceived style of how the portfolio company is led (entrepreneurial vs managerial). In order to contribute to the research domain, it therefore would not be suitable to conduct a single case study since the results would be biased. It would therefore not adequately contribute to a

better understanding of how the VC industry behaves, both in regard to utilisation of control forms, but also in an innovation context. For the study's purpose, there is instead a need to portray an image of the industry, which is as accurate as possible, which is why a multiple case study suits the study's purpose (Lillis & Mundy, 2005).

Even though a multiple case study is conducted, the authors recognise that it will still be difficult to portray a fair image of the industry as a whole, given the time frame for the study and difficulties with finding VC firms willing to participate. On the other hand, the research domain has very limited coverage as of now which is why the paper contributes to a better understanding of the topic and aims to provide a reference point for further research, despite its limitations. A multiple case study is therefore particularly suiting, since it allows the authors to investigate a phenomenon of medium/high complexity, despite the lack of previous literature (Agndal & Nilsson, 2010; Ferreira & Merchant, 1992; Lillis & Mundy, 2005).

3.2 Data collection

The study has been based primarily on in-depth interviews. As a secondary source of information, internal documents provided by the company and information from the respective company websites have been used. A total of 15 interviews were held with 12 VC companies between February and April during the spring of 2022 (See Table 1). The purpose of the interviews was to provide a picture of how the VC firm sees the design of the steering over their portfolio companies. Hence the data collected is from the perspective of the VC firms, and not their portfolio companies. As highlighted by Orlikowski & Gash (1994) interviews provide a great foundation for stimulating discussion and gathering in-depth facts. Furthermore, Yin (2014) elaborates that interviews are a critical resource when conducting qualitative studies.

The interviews followed a semi-structured approach, meaning that the questions are based on a few predetermined questions, but the discussion then goes in a given direction depending on the interviewee's response and new questions emerge. When choosing the interview approach and what type of questions asked, the authors followed the advice from both King et al. (2019) and Lundahl & Skärvard (2016). According to Rowley (2012) the structure of the interviewees can be divided into three distinct categories, i.e., semi-structured, unstructured, and structured. Unstructured interviews are not based on predetermined questions, but the interviewer can instead ask questions that come to mind during the interview process. Structured interviews are the opposite and is when the interviewer only asks the interviewee the predetermined questions with no room for adaptability or flexibility. A semi-structured approach lies in between the two. This method has been recommended to novice researchers as ourselves, as it enables adaptability and flexibility (Bryman 2012; Rowley, 2012). In addition to the flexibility and adaptability given by the unstructured approach, the authors also favoured that the approach gave room for additional insights to be drawn and elaborated on during the interview.

The goal was to hold all interviews in person, as the authors regard that physical interviews facilitate a more in-depth conversation, compared to online interviews. However, due to reasons such as the Covid-19 pandemic, most interviewees preferred to meet online. In total, 9 interviews were held on Microsoft Teams or Zoom, and 6 in person. Before conducting the interviews, we informed the VC firms of their anonymity, as firms often hesitate to disclose firm-specific information if they are not given anonymity. In conjunction with this, each interviewee was asked to sign a GDPR form, to make sure both parties were in agreement considering the use of the data collected. Given the often observed busy schedule of the interviewees, the length of the interviews varied, with the average interview lasting approximately 45 minutes. Both authors were present during all interviewees and took turns of being in charge of the questions and taking notes.

All interviews started with an introduction of the interviewee's professional background followed by a brief introduction of the VC firm. This was done to gain some background perspective on both the employee and the firm. This was then followed by a question of how the companies define innovation, and work with it in its portfolio companies. Given the unstructured interview approach, the interview then took different paths as we set out to gain a deeper understanding not only of how the firms work with MCS, but also how they manage the potential tension between control and innovation in its portfolio companies.

After a few interviews we understood that the word control has a very negative association in VC, and some argued that it even did not exist. Therefore, we calibrated our wordings as the interviews went on and spent more time on initially explaining what we meant by control. E.g., many interviewees would not themselves define *social* and *contractual controls* as actual control forms and therefore we had to clarify that, before starting the interviews.

Company	# of interviews	Interviewee(s)	Relative size	Date
Calla Lily Capital	1	Partner	Small	2022-03-15
Daisy Capital	1	Investment Manager	Medium	2022-03-22
Gardenia Capital	1	Partner	Small	2022-02-03
Carnation Capital	1	Partner	Medium	2022-03-08
Orchid Capital	2	Partner, Investment Analyst	Large	2022-03-07; 2022-03-25
Tulip Capital	1	Partner	Medium	2022-03-09
Peony Capital	1	Investment Associate	Large	2022-03-03
Dahlia Capital	3	Partner (1), Vice President (2)	Medium	2022-03-02; 2022-03-10; 2022-04-19
Marigold Capital	1	Partner	Small	2022-03-18
Aster Capital	1	Investment Analyst	Medium	2022-03-26
Azalea Capital	1	Investment Analyst	Small	2022-04-20
Crocus Capital	1	Investment Analyst	Medium	2022-04-22

Table 1: Summary of interviewees

3.3 Qualitative data analysis

The study was conducted using an abductive approach, implying that theory development, collection of empirical data and analysis was handled iteratively by continuously standing the theoretical chapter in contrast to the findings (Ahrens & Chapman, 2006; Lukka & Modell, 2010, Dubois & Gadde, 2014). The study has therefore been formed sequentially as the authors' knowledge depth of the topic has increased. In order to form the study according to this abductive approach, insights from every interview were noted and discussed after each interview. Because of the importance of gathering a large population in order to produce a fair view of the industry, only one follow-up interview was scheduled. Instead, there was a focus to meet with different people, to get different perspectives in order to form a comprehensive view. Any follow-up question was instead asked by email. This approach enabled the authors to develop the empirical chapter according to its needs, along with a greater understanding of the topic.

The authors' divided the collection of empirical data into two steps. After the first half of the interviews were conducted, a first draft of our findings was structured and put to words, in order form a clear view of the initial findings and what they represented. These initial findings were thereafter discussed in order to increase the captured data quality during the second half of interviews. This, since the authors framed the second half of interviews according to the initial findings, putting emphasis on gathering the most valuable insights. This process included both covering information gaps, but also focusing on data collection in the areas which were indicated to provide greatest importance to answer the paper's research questions. Furthermore, classifications of the control forms included in the Bedford & Ditillo (2021) framework were not introduced to participants, in order to remove potential bias and instead capture a more natural view of their attitude towards the different control forms.
Instead, the authors' themselves drew connections to the framework's classifications during the development of the empirical chapter.

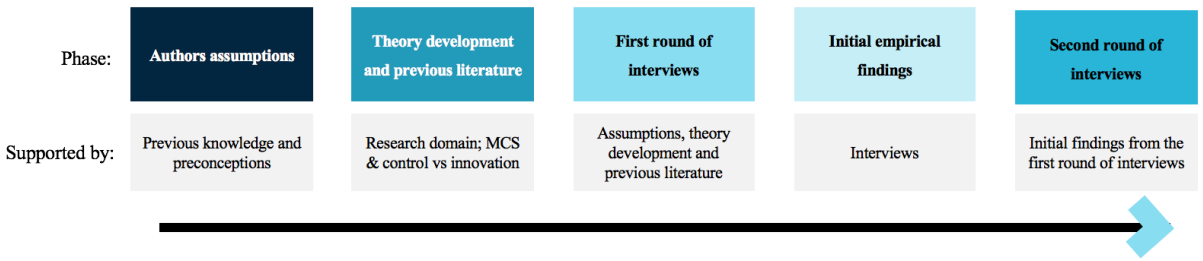

Figure 4: Qualitative data process

3.4 Data quality

Data quality has historically been assessed by the reliability and validity of the data (Yin, 2014). Lundahl and Skärvard (2016) talks about the importance of reliability and replicability of a study, i.e., a third party should with instructions be able to replicate and get the same

results with the same data. Dubois & Gadde (2014) argue that this assessment is based on a quantitative approach, hence not optimal when using a qualitative approach, such as this paper.

Lukka and Modell (2010) instead suggest assessing the quality of the data through authenticity, plausibility, and trustworthiness. Authenticity refers to creating a narrative that provides the interviewees with a voice, rather than the other way around, i.e., letting the interviewees speak for themselves. The authors have interviewed several people from different companies, in order to avoid a potential bias and to create a more nuanced picture. Plausibility refers to the reasoning in the paper and Lukka and Modell (2010) argues that it is important to have a coherent reasoning throughout the paper that makes sense. Questionable reasoning might give reason for the reader to question the plausibility of the essay and hence question the authors. To establish plausibility the authors have created a coherent red thread throughout the paper where past research is the foundation on which new discoveries are built. Trustworthiness refers to the credibility of the data and the construction of the study in a correct and viable manner (Lukka and Modell, 2010). Furthermore, it entails that the data should be transferable and usable by other researchers, potentially in other fields. To comply with trustworthiness, the authors have, in addition to only interviewing qualified professionals, only included spoken answers, and hence not tried to interpret e.g., body language and gestures.

4. Empirical analysis

The paper's fourth chapter consists of the empirical analysis based on the responses from the conducted interviews. In section 4.1, what innovation means for VC firms and why they consider it important is discussed. In section 4.2, each control form of the Bedford & Ditillo (2021) framework is discussed. Finally in section 4.3, individual firm characteristics affecting prioritisation and utilisation between the control forms are discussed with the aim to provide a view of the VC industry as accurately as possible.

4.1 Innovation in venture capital

4.1.1 What is innovation for VC firms and why do they consider it so important?

The interviews show that innovation is crucial in venture capital, and if the portfolio companies are not innovative enough, they will not succeed. Furthermore, innovation can be defined on the basis of replicability and stems from the founder of the company.

The definition of innovation is ambiguous, although similarities could be identified between the respondents. A common way of analysing innovation was to break it down in several parts. The most common elements were product, technology, and business model and in order for a firm to be innovative, at least one of the three had to be unique. Uniqueness was often referred to as a scale of replicability, i.e., the lower the replicability, the higher the innovation. Some of the interviewees stated that if the business model consisted of several elements, the element in itself did not have to be unique, given that replicability of all elements was hard. One respondent defined innovation as finding the right context and the right team, creating a contrast compared to the other interviewees. Another interviewee discussed innovation as disrupting the value chain.

"Innovation can be a variety of different things, depending on who you ask. For us it does not have to be a new innovative product, but instead it can be related to e.g., disrupting the value chain, in which more value can be extracted from." – Partner, Calla Lily Capital

The importance of innovation could not have been understated by the interviewees. All respondents emphasised the importance of innovation when evaluating potential investments. Given the high growth targets in VC, innovation works as the catalysator to the growth. Companies with low innovation might be good and profitable companies, but they will not reach the highly set growth targets that VC firms expect.

"We often come across great companies, managed in an efficient way that produces solid cash flows and profitability. However, if these companies are neither unique nor innovative, we can't rationalise investing in the company. This is because we know that these companies will not be able to meet our high growth targets, as they are not disruptive enough."
– Partner, Gardenia Capital

When screening for innovation the company's processes differed. One of the respondents emphasised its technological due diligence, where the CTO of the company evaluated the code behind the algorithm to better understand both the business and the risk of replication, i.e., the degree of innovation. However, more importantly there was a strong coherent view that the founder of the company was critical to the innovation of the company. Hence, companies that did not seem innovative during the screening process would most likely not develop innovative ideas later on. Furthermore, our interviews imply that the source of innovation is individuals rather than technology assets, from VC firms' point of view. It is the founder which has built the company from the start and made it a plausible investment opportunity. VC firms therefore, to a great extent, value the founders' ability to innovate and accelerate the business rather than looking at present assets within the company. Hence VC firms expect the founders to take responsibility for the continued innovation. Furthermore, previous research has classified VC firms as strategic advisors to the portfolio companies, (see section 2.2.2). We observe some traces of exercising a more strategic role, but their role as strategic advisors may seem weaker than previous research indicated. Interestingly, only a few of the interviewees describe their role as strategic, although they expressed how they support founders with various tasks such as networking and specific challenges. Instead, they rather framed their role as a mentor, with a lesser connection to the decision process of deciding strategic direction. However, it is unclear whether this is yet another attempt to disguise monitoring and that the role actually could be described as a strategic advisor. This, since VC firms are keen to be perceived as founder-friendly. As previously stated, innovation is closely tied to individuals and VC firms want the founders to truly have the feeling of not being restricted, so it makes sense for them to disguise their role as "mentors", in order to not disturb the founders, and as a consequence not hinder them to innovate.

"Our investment philosophy is to really understand the founders behind the company. Fully understanding them and their capabilities to innovate, is the major key behind an investment. They are totally responsible for how the company will develop, and if it will succeed".
– Partner, Calla Lily Capital

"We need the founders to focus on what made their company an interesting investment opportunity in the first place - creating a disruptive product or service that the world has not seen before. We therefore must respect the freedom of the founders" – Vice President, Dahlia Capital

"We tend to be rather laid-back and friendly towards the founders. Of course it's important to be friendly, also from a marketing perspective I think" – Investment Analyst, Aster Capital

"The best companies have innovation in their DNA… Over time, culture is totally decisive for a company's success. The founders need to build some kind of cult around their company, it is their responsibility. Culture beats structure 100 times out of a 100." – Partner, Tulip Capital

As highlighted by the quote above, it seems that the best companies have innovation in their DNA, and thus it is difficult to change. Given the founders' strong influence on the corporate culture in early-stage companies, corporate culture is strongly related to innovation, and the founders are in charge of directing them. This further supports the thesis that innovation is closely tied to individuals in a VC setting. Apart from this, innovation is defined on the basis of replicability and its importance is hard to question. Section 4.2 will now utilise the Bedford & Ditillo (2021) framework to dive deeper into the innovation topic by putting it in relation to control.

4.2 Using management control to manage innovation

To structure the following empirical analysis, we have used the four control forms in the Bedford & Ditillo (2021) framework; *contractual controls, results controls, behaviour controls and social controls*. The following sections will present the analysis of each of the control forms.

4.2.1 Contractual controls

Contractual controls are binding agreements that detail rights and obligations by each party (Poppo & Zenger, 2002). Our interviews signalise that *contractual controls* are of great importance in VC. This is in line with the limited previous literature (Bedford & Ditillo, 2021; Gompers, 1995). The shareholder agreement (SHA) is the foundation for *contractual controls* and enables VC firms to achieve control whilst not creating any disturbing noise in the organisation.

The SHA constitutes the shareholders' rights and obligations and defines how a company should be operated. It stipulates privileges and protection rights for the shareholders and how much control and flexibility investors are given, including to which extent they can exercise governance activities. For VC firms, the SHA serves as the foundation for the firm's overall control of their portfolio companies, in line with Gompers (1995) findings.

The interviewees commonly mentioned two specific clauses of importance. Firstly, the option to distribute or stop the funding, based on a specific event or a disappointing development for the company. This is often managed through splitting the funding into different tranches, i.e., further funding is only made accessible in the event of certain conditions being fulfilled. These clauses are therefore typically linked to the *results control* system. It is seen as a good way to exercise control whilst not interfering directly with the operations. Founders have these conditions in the back-of-their minds, but they do not affect day-to-day decision making. Previous research has noted the importance of such clauses, and the concept has in the literature been referred to as incremental financing (Gompers, 1995).

"Before entering an investment, we always demand a comprehensive go-to-market plan including relevant forecasts, KPIs, market data, etc. Key indicators in the plan are thereafter made formal through the SHA, for example by giving us the right to exit the investment in the case that the company's performance strongly deviates from what was communicated as a probable development". – Partner, Gardenia Capital

Secondly, the right to invest in order to not be diluted if a subsequent financing round is decided was something frequently mentioned in the interviews (i.e., a pro-rata right). The option to exercise pro-rata rights are important to new potential investors in the event of an additional financing round. An investor holding such a right deciding to not invest implies a willingness to decrease ownership percentage. Such a move therefore creates a negative signalling effect and can affect the success of the financing round substantially. Hence, the pro-rata rights give the VC firms great power, and therefore control since these two are linked. Similarly to incremental financing, pro-rata rights do not directly interfere with daily operations but rather achieves control seamlessly, which is another aspect that VC firms value with the concept.

"The pro-rata rights represent our strongest control form, especially for us as early-stage investors. If one of the cornerstone investors jump the ship in one of the early seed-rounds, it will be impossible for that company to attract other investors. In addition, it is rather standardised within the industry which means founders easily approve it. We thereby can achieve some control without founders actually thinking about it" – Partner, Calla Lily Capital

Previous research indicates that a main function for *contractual control* was to mitigate potential agency costs and secure goal alignment. Because of this, Gompers (1995) argued that *contractual control* hinders moral hazard problems. However, our interview responses do not support this view but rather indicate the moral hazard problem to be handled through *social controls* (see section 4.2.7). This, since VC firms aim to truly understand the founders' rationale already prior to the investment, rather than in conjunction with it. Instead, our interviews indicate that the main role of *contractual control* is to support the *social controls* through a formalised way. Given the lack of formality in *social controls,* which is a large part of a VC firm's MCS, *contractual controls* serve an important and supportive function to ensure some kind of formality in their governance procedure.

"The SHA helps us to protect our rights and I guess you could say is the backbone of our control activities. In contrast to our counterparties in buyout funds, we have a greater faith in the entrepreneurs and build our governance activities through that faith. It is therefore important to achieve some kind of more structural control" – Investment manager, Daisy Capital

Furthermore, our interviewees point towards a non-existing relationship between *contractual controls* and innovation. This indicates that the utilisation of *contractual controls* does not affect or hinder innovation in the portfolio companies. The rationale for this is that *contractual controls*, albeit effective, are static in nature and do not affect or interfere with day-to-day operations. Thus, *contractual controls* do not take away important time or focus from the entrepreneur. Since *contractual controls* are not perceived to interfere with the founders who are regarded as the main drivers of innovation, *contractual controls'* effect on innovation also becomes non-existent.

"Of course, we include contractual terms giving us some flexibility when signing a new deal. But if we would ever need to utilise some of these clauses it is already too late, we have already made a terrible investment and there's nothing to do about it. I therefore don't think any contractual terms can be said to limit the innovation in our portfolio companies."
– Partner, Dahlia Capital

On the other hand, some interviewees mentioned how linking the go-to-market strategy to the contractual terms put pressure on the portfolio company to perform. Since accessing additional funding is crucial for many early-stage companies with VC investors, they are incentivised to focus on reaching the targets in order to continue their development. Focus should therefore shift from innovating to growth and increased profitability. Whilst these factors often correlate with each other (at least innovating and growth), it is not always the case. Furthermore, most of the interviewees mentioned that the founders are absolutely key for the innovation process and turning their focus towards succeeding financially could therefore limit their contribution to the innovation process. However, all in all, our findings point towards no effect on innovation through utilisation of *contractual controls*.

"Some founders are just unrealistic about their future and up in the clouds with their thoughts. They want to change the world and are extremely passionate about what they are doing, prioritising financial performance as second but rather sees it as a long-term objective. We therefore serve an important function to keep them on the ground and stay realistic. We like when portfolio companies scale up sequentially, since this enables them to test the water and us to realise what the actual value of their products is. We secure this through linking goals in the go-to-market strategy to the contractual terms." – Partner Gardenia Capital

In sum, the two most important *contractual control* forms are the shareholder agreement and the pro rata rights. In addition, it is clear that *contractual controls* constitute an important control form for VC firms as it enables the firms to assert control without being perceived as interfering, and hence it does not hinder innovation development.

4.2.2 Results controls

Results control concerns monitoring, KPIs, budget, strategy and incentive schemes for the portfolio companies' personnel and founders (Bedford & Ditillo, 2021). Our findings implies that VC firms' utilisation of *results control* towards their portfolio companies is aimed to be perceived as limited, even though it is utilised to some extent. Whilst monitoring activities is communicated as detrimental, VC firms seem to actively work with incentive schemes and goal setting techniques. This indicates that VC firms only aim to openly use the *result control* methods which do not interfere with day-to-day operations and does not take away any focus from the founders.

The empirics show that VC firms do not want to get too involved in the process of how their portfolio companies monitor their results and how they decide what KPIs to measure. However, previous research (see section 2.2.3), indicates that VC firms are prepared to pay a premium for firms with well-developed monitoring and measuring systems in place. This indicates that VC firms like companies that measure the right things, and know what drives their business. Hence, there seems to be a correlation between what VC firms regard as good companies, and companies that measure the right thing with adequate measuring systems in place. This nuances previous research on why VC firms pay a premium for these types of firms. One interviewee said that if you must change what is measured, the company is already going in the wrong direction.

"We have no intention to develop any monitoring systems for the portfolio companies ourselves, its existence is rather a prerequisite for us in order to invest". - Partner, Carnation Capital

"If we as investors have better knowledge of what to measure than the management of the company, it is clear that we have made a bad investment". – Partner, Orchid Capital

On the other hand, whilst monitoring activities are widely stated to be unpopular, VC firms still use quarterly or monthly financial reports to follow the performance of their holdings. The content of these reports differs, and can be both a high-level perspective of the performance, or a more detailed one including KPIs, budget allocation, etc. Whilst interviewees were not keen on referring to these reports as monitoring tools, they actually are, according to the Bedford & Ditillo (2021) framework. In addition, when the VC firm has board seats, they go one step further and practically disguise their monitoring activities as a natural part of the role. Furthermore, our interviews point towards little involvement from the VC firm when setting the budget in the portfolio company. However, in certain instances where the VC firm had board seats, they were part of approving the budget, but not part of creating it. Even though the proposed budget seldom changes to a large extent according to the interviewees, the process could still be seen as a monitoring activity. Furthermore, incentive schemes and goal setting are two methods which are actually commonly adapted. Since VC firms restrict utilisation of the *results control* system because they do not want to

intervene in the operations in order to enable freedom, incentive schemes and goal setting are more or less the only way to somehow control and shape the employees' behaviour in the portfolio companies without being disturbing and creating buzz possible to restrict innovation. It is therefore not surprising that the presence of incentive schemes for employees in portfolio companies seems to be very high and prioritised by VC firms. It almost seems like their importance is increased as other *results control* measures are limited.

"Aligning the incentives is all about being on the same page. If the portfolio company shows progress and becomes successful, we must make sure that it is not only the VC firm that benefits". – Partner, Orchid Capital

"We offer incentive programs for employees in every company we invest in. Not only the management team, but for all functions. This is a critical policy instrument for us in order to enrich the employees and get them to understand that they are the actual engine behind the company, that they are what really matters for us" – Investment Associate, Peony Capital

"Our portfolio company sets their own strategic agenda and come to us only if they need advice or mentoring. They know their business model substantially better than we do, and it would not make sense for us to interfere with their strategic view" – Partner, Tulip Capital

Practically, incentive schemes are set up by offering the executive management and board equity options, while simultaneously making sure the entrepreneur still retains a sizable stake in the company. One of the firms interviewed went to the extreme, by offering equity options to the entire company to make sure 100% alignment. In conjunction with options, the interviewees mentioned that the firms implemented lock-ups associated with the options, to also align the time-horizon between the company and the investors. A lock-up contractually prohibits a person to sell his share for a given time period.

It is clear that *results control*, although limited, is present but aimed to stay hidden towards founders and management of the portfolio companies. This is supported by the fact that the aforementioned activities (goal setting and incentive schemes), can be defined as *result control* activities and have in common to not be perceived as disturbing. In other words, VC firms want, and try, to use *results control* to some extent but they are reluctant to show it. Operational engagement through perceived monitoring, having a say in what to measure, etc. comes with a hefty price tag – leaving the founders a feeling of being supervised and being told what to do, disturbing them and eventually demanding them to redirect focus. In this way, VC firms take an active decision to limit *results control* activities which are perceived as interfering in order to not constrain innovation.

4.2.3 Behavioural controls

In line with previous research (see section 2.4.1), we do not find adoption of *behavioural controls* to be present in a VC setting. The interviewees were all sceptical to implementing rules, boundaries and new procedures in its portfolio companies. Several of the respondents referred to it as "micromanaging" and detrimental to the development and growth of the portfolio company. There was a clear desire to limit this kind of behaviour to a great extent.

"When you start micromanaging your portfolio companies, you are in deep trouble. Venture capital is all about freedom with responsibilities". – Partner, Tulip Capital

Furthermore, one of the interviewees discussed the implementation of the VC firm's code of conduct in their portfolio companies. However, this was done just before exiting an investment and the rationale was to "tick the boxes" rather than anything else. The rationale for this goes back to what has been discussed continuously in this paper. When VC firms invest in a company, they invest in an entrepreneur and the idea that the entrepreneur has. When the VC firm starts to manage too much, they eventually start to take over the company, and the founder thereby gets thrown out of the driving seat. Since VC investments are much about investing in people, interfering too much somewhat deletes the idea behind VC and its function in financial markets. This line of reasoning might explain why there is very limited research regarding *behavioural controls* in VC companies.

The rationale for not using *behavioural controls* can also be linked to the innovation aspect. A common argumentation from the respondents was that micromanaging can demotivate the founders, which in the long run could lead to a decrease in innovation in the company. The demotivation happens because when investors take too much control, it creates a misalignment between what the entrepreneur and VC firms see as the way going forward. Since the founders are seen as the driving force behind the innovation, they need to be motivated and if they are not, the entire company will be affected. Although the investors have tools to mitigate demotivation, e.g., workshops and advisory boards, these support systems require the entrepreneur to be motivated and will not by itself create the much needed innovation.

"If we would start creating problems for our portfolio companies' founders by constantly watching their back and telling them what things to do and how they should do it, they will eventually become very tired of us and in a worst case scenario walk out the door" – Partner, Marigold Capital

Furthermore, one interviewee mentioned that the current investment climate with more easy-accessible capital than previously has contributed to a situation where founders can be pickier with their investors' involvement, when evaluating new investments in their company. This, since lending rates from financial institutions are historically low, whilst the VC industry has

become more competitive through high capital inflows and more active VC firms seeking to invest.

"The venture capital industry has developed to become much more friendly towards the founders. Previously, we were more similar to buy-out funds and demanded greater control over our holdings. I think the industry has become very competitive with the massive capital inflows which has resulted that we need to be pragmatic towards the founders in order to stay competitive, to be able to invest in the best companies and founders." – Investment manager, Daisy Capital

In addition, implementing and supervising new policies is time consuming and takes away the founder's focus, which also could hinder innovation. In addition, bureaucracy and procedures generally do not go well with the type of companies VC firms typically invest in. This, since high growth companies require a flexible and adaptable structure as the surrounding environment is constantly changing. Implementing policies and rules can lead to bureaucracy and red tape in the organisation which would lead to a slower reaction time to the market and decreased innovation. Furthermore, the smaller size of the portfolio companies would also make them less suitable to policies and rules. This would further explain the reluctance to implement *behavioural controls*.

4.2.4 Social controls

Social controls include social networks in the organisations, trust, interaction, joint decision making etc. Our interviews implies that *social controls* are of great importance for VC firms. They seem to serve a crucial role throughout the entire period of investment in a company. In addition, our interviews clearly indicate that trust is the most important variable for the *social controls* system, which is in line with Decker (2004).

Since the *results control* and *behavioural controls* systems are purposely limited, trust seems to become crucial throughout the entire holding period since insight into the portfolio companies is relatively low. Furthermore, the establishment of trust happens already before an investment. There is no desire to improve trust throughout the holding period, it is rather a prerequisite to enter. The first box to tick when evaluating an investment possibility seems to be if the VC firm truly likes and trusts the founders, and acquiring it seems to happen in different ways. Prior to investing, multiple interviewees mentioned the human due diligence process to be absolutely critical. The human due diligence process involves an assessment of the founder's personalities, motives, skillset, background to get a deep understanding about the person behind the business.

"The most important function in our due-diligence process is to get under the nails on the founders. We have to understand the motive behind starting this company, in this industry, and what their actual main goal is. We like to ask ourselves three simple questions when evaluating an investment: Do we like the founders, and do we like the idea? If the answer is

yes to these two questions, we ask ourselves whether we like the founders so much that we would want to invest in him or her, even though it was a completely different business in another industry. Only if the answer is yes to all of these three, we choose to invest."
– Partner, Tulip Capital

"When founders present their strategy plan ahead for us prior to an investment we ask them to validate pretty much every forecast figure. Then we listen closely to get a feeling for how much they actually know, or if they are full of bullshit and just want to secure an investment with an aggressive growth multiple" – Partner, Gardenia Capital

Our research implies that the human due-diligence process is even more important than the technological due diligence process, mentioned in section 4.1.1. When a company is acquired, trust is continuously maintained through informal communication. Even though portfolio companies send monthly/quarterly updates regarding their performance, the most valuable form of communication for VC firms seems to be the regular contact between them and the founders in order to stay-in-touch, getting a gut feeling for how the company is doing. These chats could be about specific challenges, market trends, networking possibilities, etc. and strengthens the relationship. Even though these chats are casual and not targeted for strategic influence, their frequency is very high. This means that they actually form an important control function for VC companies, both in order to monitor their portfolio companies, but also influencing them through subconscious idea planting. The dynamics and importance of informal interactions is complicated, but very interesting. This, since the control activity's importance for the MCS as a whole seems to increase, just because of the fact that the founders perceive it as weak. In other words, because the founders do not perceive that they are being controlled, the control activity strengthens. This is particularly interesting since the control activity in fact is very interfering, since it is intense and demands the founder's attention. An explanation for the phenomenon is that the control activity goes well in hand with being perceived as founder-friendly, in some extreme cases the founders could almost see the VC professional as a friend.

"I am on the phone with the founders and management team of our portfolio companies every day and these conversations take up a lot of time during my week. These conversations are very informal, we can talk about everything, it can be business related or discussing a football game that is taking place on the weekend. I do not see these informal chats as a way of steering, but rather as part of our cooperation. However, whilst not directly influencing strategic decisions through these chats, of course you can sometimes plant an idea to the founder that might steer him/her in a direction that is favoured by us. – Partner, Carnation Capital

"The target is never to exercise control, it is to make the founders think like you do. Important decisions are taken ad-hoc through informal chats at 10 PM on a Tuesday on WhatsApp. When we get to board meetings, everything is already decided" – Investment Manager, Daisy Capital

Furthermore, the informal interaction can also be argued to function as an innovation enabler. This, since the discussions can provide a different, broader perspective to the founders. For example, they can cover recent technological developments in the VC firm's other portfolio companies, or in adjacent industries which the VC firm follows. This type of information can thereafter be analysed by the founder to understand whether their own firm can benefit from this new information.

"We speak regularly with our portfolio companies, our discussions have no clear agenda but it is rather a tool for us to get a feeling for how they are doing, and for them to ask any broad questions regarding recent market or tech development for example". – Investment Associate, Peony Capital

In addition to trust, a great culture in portfolio companies seems to be highly valued by VC firms. Similarly to trust, culture is evaluated already prior to an investment. Furthermore, after entering an investment it is very rare that the VC firm engages to actively change the culture. This, because changing the culture is very difficult, but also there is a need to keep respecting the founder's freedom which is based on trust.

"Over time, culture is totally decisive for a company's success. Culture beats structures hundred times out of a hundred. It is key in order to attract talent, which is very hard especially in the tech-scene. Nowadays people do not want to work at companies whose sole purpose is just to make money." – Partner, Tulip Capital

"It is extremely difficult for us to actually affect the culture. We tend to just evaluate and get a feeling for it prior to the investment, but it is extremely rare that we take an active role in changing it in a portfolio company, then something must have gone terribly wrong."
- Partner, Calla Lily Capital

"We bet on a culture rather than trying to change or steer it in a specific direction"
- Partner, Carnation Capital

However, even though specific actions to change culture seem to be down-prioritised, some firms work with methods which can be argued to strengthen the cohesion, increase interaction, and transfer knowledge between the portfolio companies.

"*Once every quarter, we arrange a conference with key personnel from all of our portfolio companies and they get the chance to interact with each other. We always have a specific theme, for example it could be artificial intelligence. We start the day with a keynote speaker, which is thereafter followed by informal discussions between our people so they can ask questions and perhaps learn something from each other. These events have been highly appreciated by our portfolio companies since the start.* – Partner, Tulip Capital

These types of events were mentioned by several representatives from different firms. They are much about enabling learning with a main goal of coming up with new ideas for management to implement in the different portfolio companies. On the other hand, they can also be argued to strengthen the culture since group cohesion is improved. This, since key individuals get the feeling they belong to something bigger and powerful, a feeling that later gets transpondered downstream in the organisational hierarchy since culture starts from the top. The get-together events for management in the different portfolio companies can also be argued contributing to innovation because of the forums' structural liberty, which result in high-level discussions constituting of open-ended questions that are not normally discussed in a portfolio company which internally have a narrower focus on its day-to-day operations.

Furthermore, *social control's* importance from an innovation perspective is strengthened by the fact that the founder's personality seems to reflect how the company behaves as a whole. If there is a very optimistic and ambitious founder with the aim to take a quantum jump with its business, it is very likely that this ambitious mindset is transferred over to other organisational members. This means that by conducting the human due diligence process, and thereby truly understanding the founders, the VC firm achieves insights on how the target company actually reasons and values innovation. The insights are later taken into consideration when deciding whether to invest or not. Furthermore, it builds on trust to the founders, i.e., a conviction that the founders are not portraying an inaccurate picture of themselves, nor their company.

"A founder's personality basically is their company's personality. If a company have a founder which is highly energetic with a massive innovation focus, it is very likely this view is represented throughout his or her organisation" – Partner, Dahlia Capital

4.3 Firm characteristics affecting utilisation and prioritisation between the different control forms

As discussed throughout the paper and as seen in the differences between the answers in the empirical section, VC firms are to a large extent formed by individual characteristics. However, we have identified three main variables which affect the degree of utilisation, and prioritisation between the different control forms.

Firstly, the relation between the quantity of portfolio companies and headcount at the VC firm is important. A high number of portfolio companies, whilst few people working at the VC firm indicates less time to invest per portfolio company. In this case, *contractual controls* and *social controls* become increasingly important, as achieving control through operational involvement by utilising other control forms is less possible. *Contractual controls* constitute static control with no operational involvement at all, so trusting the founders becomes very important in such a scenario, especially since time for the important informal chats is limited. Furthermore, in such a scenario, *results control* utilisation therefore also decreases since there is simply less time for monitoring.

"We have c. 45 portfolio companies but only a couple of employees - it would be impossible for us to constantly monitor our holdings performance" – Partner, Carnation Capital

Secondly, the stage of investment matters. For early-stage investments, equity tickets are lower and risk is higher since the target company is less proven. In addition, the target company's direction can develop and shift throughout the growth journey. Because of this, *contractual controls* are more important in early-stage investments. In later stages of the organisational life-cycle, the findings indicate that operational involvement (and therefore *results control*) increases which is logical since there is more at-stake for the VC firm, and thereby the need for *contractual controls* decreases. *Social controls* are of great importance throughout the entire holding period.

Lastly, the ownership stake matters which is in line with Bedford & Ditillos (1995) argumentation that the importance of control forms differs depending on ownership style (minority vs majority). However, ownership stake purely based on equity ticket size also seems to matter. One interviewee mentioned that there is a correlation between money at stake and *results control* utilisation.

"In the early stages of an investment, when little money is put in, we do not have the resources to monitor everything closely. However, in the later stages of an investment e.g., a series C round, a large part of the fund's value might be attributable to a single investment. In these cases, we follow the investments closely as the risk has substantially increased."
– Partner, Dahlia Capital

This means that in the early stages, when little money is put into the company, monitoring activities are limited because the money at risk is small. However, after several rounds of financing and more money put into the company, monitoring activities will increase because now a large portion of the fund value might be in a single investment. Furthermore, our interviews indicate that *contractual controls*' importance have a negative correlation with ownership stake, i.e., greater ownership implies less need for *contractual controls*. The reason for this is the same as for the first and second identified variables, i.e., other control forms take a greater role at later stages in the organisational life-cycle, which diminishes the role of *contractual controls*.

5. Concluding discussion

The paper's fifth chapter consists of a concluding discussion. Firstly, section 5.1 outlines our findings with regards to VC firms' view on innovation, while section 5.2 discusses our findings in relation to perceived interference or non-interference contributing to the utilisation of specific control activities. Section 5.3 aims to contribute to a better understanding of the utilisation of control activities in a context of innovation and the Bedford & Ditillo (2021) framework. Finally, section 5.4 concludes our paper, discusses potential limitations of the study, and suggests new research areas within the field.

5.1 VC firms' view on innovation

Our findings suggest that innovation is extremely important for VC firms (see section 4.1.1), which does not come as a surprise given the nature of the VC industry, i.e., investing in emerging technological companies. More interestingly, however, is that there seems to be a coherent view that innovation stems from the individuals, rather than technological assets within the firm. As a consequence, the importance of the founders, who have come up with the original idea that made the company an interesting investment target in the first place, is very high. VC therefore takes a rather humble approach compared to the broader private equity domain, and the individuals behind their investments are valued higher. The respect for entrepreneurial freedom is great. Because of the great respect, it is reasonable that VC firms value trust highly in their investment process. They need to trust founders profoundly in order to make an investment. They therefore do not enter into companies where they do not trust the founders' capabilities to make great decisions. Thus, there is no need to interfere with operations and start micromanaging, and it becomes easy to take on the role of being "founder-friendly". This also explains the neglect to form or change the MCS within their portfolio companies which is indicated by both our findings and previous research (Meyssonnier, 2015; Granlund & Taipaleenmaki, 2005). Furthermore, it is hard to neglect the general market environment's impact. As mentioned in section 1, fund inflows for European VC firms broke the EUR 100bn mark at an all-time high in 2021, corresponding to a YoY increase of >100% (European Venture Report - Pitchbook, 2021) As the supply of money has exploded, the best companies seeking investments now have more options to choose from, and therefore can demand more. For this reason, the importance of being perceived as founder-friendly has increased, which one interviewee also mentioned (see section 4.2.5)

In order to respect entrepreneurial freedom and enable innovation, being perceived as "founder friendly" has become important in the VC industry. However, it is unquestionable that there is a tension present between founder-friendliness and achieving control, since the two concepts represent opposite ways of acting in the role as an investor. Whilst VC firms urge to be perceived as founder friendly, they are still financially oriented investors with the sole goal of seeking profit, as a result there is a strong pressure towards increasing sales and profitability. In addition, limited partners (external investors) demand that their money is invested wisely since they pay a fee for the service. If they are not satisfied, they will simply

withdraw their money and turn to a competitor. Consequently, there is a strong pressure on VC firms to make adequate investment decisions and be well informed about the activity in their holding companies, in order to succeed. In contrast, founder-friendliness signals freedom, laissez-faire, and trust. VC firms are therefore required to solve the difficult task of achieving control, whilst still being perceived as founder-friendly. So how do they do it? To some extent, they manage this task by operating in disguise.

5.2 Perceived interference or non-interference determines the utilisation level of specific control activities

Our findings suggest that it is not the specific control activity that decides if innovation is hindered, but rather if the control activity is perceived as interfering with day-to-day operations. Control activities can be classified as either interfering or non-interfering, but the VC firms can actively work to change how they are perceived. We therefore identify a new way to classify control; a control activity is either perceived as interfering or perceived as non-interfering. Interfering is defined as disturbing, affecting day-to-day operations, and taking away the founders' focus, whilst non-interfering creates no disturbances. However, what is important is not whether the control activity is actually interfering or not, but rather how it is perceived by the founders in the portfolio company. A clear example illustrating this important difference could be seen in how VC firms view informal interactions (i.e., casual phone conversations). These are most definitely interfering since they take away the founders' focus and time. However, the founders do not realise that they are being controlled but rather see it as a casual conversation, which explains its heavy utilisation (see section 4.2.7). VC firms can collect the same information from these types of informal interactions than from classic monitoring activities – the difference is that the founders do not perceive that they are being controlled. This makes a great difference, mainly for two reasons. Firstly, VC firms do not want the founders to feel like they are slowly transforming their company by micromanaging and telling them what to do, since that could demotivate them and as a consequence hinder performance and innovation. Secondly, there seems to be a psychological aspect with a belief that the entrepreneurs might feel supervised or lied to, if they have the feeling they are being controlled. This, since VC firms can ensure their founders of retained freedom in conjunction with the investment, in order to frame themselves as an attractive funding partner.

Furthermore, VC firms excessively utilise control activities that are perceived as non-interfering, partly in order to decrease the risk of innovation loss. A founder-friendly approach can sometimes go hand-in-hand with this type of controlling activities. For example, as mentioned in section 4.2.7, *social controls* and especially informal interactions are heavily used by VC firms. In general, the informality in these interactions means that founders are relaxed and do not feel threatened, i.e., they do not feel that the conversation is a way for VC firms to assert control. In addition, this implies that founders, although subconsciously, are more inclined to adapt according to the VC firm's agenda, possibly including how to direct innovation. Not only informal interaction, but also *social controls* in general, therefore fits

perfectly to handle the tension between being founder friendly and achieving control whilst at the same time not hindering innovation, which explains its heavy utilisation.

Furthermore, whilst visible *results control* activities such as monitoring are stated as detrimental throughout the interviews (see section 4.2.3), VC firms definitely use them. However, these activities are framed, purposely hidden to not draw attention. For example, demanding quarterly or monthly investor update reports is a typical example of monitoring, but interviewees rather framed it as standard procedure, to align with the image of being founder-friendly. The excessive emphasis on incentive schemes and goal setting further supports the narrative since they are not perceived to interfere, and enable the VC firm to seamlessly achieve control. Furthermore, *behavioural controls* naturally cannot be performed without interfering, which explains the strong neglect to utilise them. *Contractual controls* are important tools since they are static and therefore the most non-interfering control form of them all. However, *social controls* still become more important since these control activities are either naturally non-interfering or easy to disguise in order to be perceived as non-interfering, even though some of them are interfering (such as informal interactions). The next section will further highlight how the control activities interplay in a context of innovation and the Bedford & Ditillo (2021) framework.

5.3 Understanding the utilisation of control activities in a context of innovation and the Bedford & Ditillo (2021) framework

5.3.1 Relationship between control and innovation

Firstly, our findings nuance the findings of the old literature domain on the relationship between control and innovation (see e.g., Rockness & Shields, 1984; Brownell, 1985; Birnberg, 1988; Abernethy & Brownell, 1997). They had a stark view that accounting-based MCS constrained innovation in a company. Accounting-based MCS is what has been referred to in this paper as *results control*. Their research was conducted in R&D environments and their general perception was connected to a view that innovation is hard to quantify and that measuring an intangible output is hindering innovation. However, in a VC setting what matters is not what you measure, but rather how the exercised control activity is perceived to affect day-to-day operations. Hence, accounting-based MCS in a VC-setting does not in itself hinder innovation, instead innovation is hindered when the founders perceive that they are being disturbed. This, since innovation is rooted in the individuals behind the company and when those individuals feel disturbed, innovation seems to suffer.

Secondly, our findings also nuance the new literature domain (see e.g., Davila, 2000; Davila & Wouters, 2004; Davila et al., 2009; Christner & Strömsten, 2015; Barros, 2019; Barros, 2021). The new research domain of control and innovation used a more encompassing definition of MCS and thus included not only *results control*, but also *social controls* and *behavioural control* and hence expanded the view on the relationship between control and innovation. Our findings are partly in line with Davila & Wouters (2004) who found that by

shifting away from traditional costing models, more time could be freed out and spent on R&D activities. This is in line with our findings about the need for management to focus on value-adding activities, which cannot be done if they are constantly disturbed by their investors. Furthermore, our findings are partly in line with Christner & Strömsten (2015) on the note that accounting-based MCS can work as both enabling and controlling. The authors focused mainly on how accounting numbers can work as a tool for both being enabling and controlling, and hence affect innovation both positively and negatively. We put this research in a VC and principal-agent setting and find that accounting numbers can affect innovation negatively if it takes away the founders focus and affects day-to-day operations with administrative tasks. If accounting based MCS, however, is disguised (by taking board seats and receiving investor updates for example), and therefore perceived as non-interfering, our findings do not indicate any negative consequences on innovation.

With this paper, we develop a new research perspective of the relationship between control and innovation, by analysing it from a principal-agent perspective, which has previously not been done, according to the best of the authors' knowledge. Furthermore, it becomes obvious to the writers that the VC firms need to use the control forms with cause, in order to not hinder innovation. This is in line with Barros (2021), who argues that some tensions cannot be removed, but instead must be managed. Hence, the next section will outline a discussion on how this is done.

5.3.2 How control forms interplay in order to not hinder innovation

According to our interviews, the *result* and *contractual controls* closely interplay with *social controls* in a VC setting, in order to achieve control. Some control activities within the Bedford & Ditillo (2021) framework are interfering, but as they are perceived as non-interfering, they are still utilised. On the flip side, we cannot identify any non-interfering control activities that are perceived as interfering. The distinction between interfering or non-interfering control activities do not seem to matter, but rather if the control activity is perceived as interfering or not. In addition, we identify no relationship between the strength of the control activity and how strong it is perceived by founders. For example, *social controls* are by nature friendly and informal, but can still be seen as a very strong control form as founders are constantly being supervised. Furthermore, the four control forms in the Bedford & Ditillo (2021) framework seem to complement each other and together add up. If one control form is lacking, another must take greater responsibility. As a consequence, every VC firm's individual MCS differs.

As aforementioned, perceived operational involvement hinders innovation. Furthermore, as discussed in section 4.2.4, generally *results control* is therefore purposely limited in most VC firms, as most *results controls* are argued to be perceived as operationally interfering. Our findings indicate this limitation to be directly correlated with the strong emphasis put on *social controls*. This is due to two main reasons. Firstly, an extensive utilisation of results control means that the VC firm can closely follow what is going on in the portfolio

companies. When this tool is removed, VC firms somehow have to gather information to justify their investment. If they can fully trust and back the motives, knowledge and experience in their portfolio company's founders, the investment risk level decreases and therefore helps to justify their holding. Secondly, the need to closely follow everything that is going on in the portfolio company is lesser if they do trust the founders. After all, if they believe in the founder and their vision – why should there be a need to intervene? The great importance of trust is supported by previous research (Dekker, 2004). In addition, our findings indicate that VC firms prefer to take on a mentoring role, rather than a strategic advisor which is more operationally involved (see section 4.2.7), once again implying that perceived operational involvement hinders innovation. Mentoring is a "softer" term, which signals less involvement, than the term strategic advisor (it also goes well in hand with the objective to be perceived as founder friendly). This stands in contrast to the findings of Graebner and Eisenhardt (2004), who argued VC firms took on a more overarching strategic role. We believe a main contributor to this change is the industry's rapid development, with VC firms becoming more founder-friendly with a greater respect for the founders as previously discussed. Furthermore, this strengthens the importance of trust as the VC firms' impact and insights are further limited by taking a step back through the mentoring role. Because of this, *social controls* seem to become even more important. On the other hand, one could argue that the VC firm's role should still be classified as a strategic advisor, since the mentoring role could just be another example of disguising in order to be perceived as founder-friendly in the eyes of the founders. To conclude, the study's overall findings indicate that VC firms' emphasis on perceived non-interfering control activities results in an increased need for *social controls* and a *results control* system tailored to not be perceived as interfering (for example by disguised activities, focusing on goal setting and incentive schemes).

Contractual controls in a VC setting represent the formalised control exercised by the VC firms. Given that *social controls* generally are favoured to *result control* activities, *contractual controls* are used as a complement to *social controls* as it decreases the reliance of trust and hence also decreases the risk of the investment. Although *social controls*, especially trust, is crucial in a VC setting, firms cannot solely rely on it since it is a very informal control form. Limited partners (external investors) demand transparency and structure to ensure their money is being handled wisely. *Contractual controls* therefore serve an important function to achieve some kind of tangible and accessible control. In addition, *contractual control* constitutes an important complement as it is the smoothest way of achieving formal control without the founders perceiving it as interfering. The lack of perceived interfering *results controls* therefore creates a controlling need that cannot be entirely covered by *social controls*, which needs to be complemented with *contractual controls*. Furthermore, as mentioned in section 4.2.1 *contractual control* is created by the use of e.g., pro rata rights included in the formalised shareholder agreements. However, some interviewees did not agree that *contractual controls* equate control, but rather viewed it as a risk mitigation tool to secure their rights. However, it became evident during the interviews that the word *control* often was conditioned with something negative in VC, and thus it would explain the reluctance of the interviewers to equate contractual agreements with control. The reluctance to accept the word

control in a VC context during interviews further supports this paper's narrative, that VC firms do not want to be perceived as controlling. Our findings regarding how control forms interplay are partly in line with previous literature, suggesting *social* and *contractual controls* to be present and important regardless of the perceived cognitive style in minority owned firms, whilst the other two control forms might diminish (Bedford & Ditillo, 2021; Dello Sbarba et. al, 2020). However, we nuance their findings by further elaborating on why they are important specifically in a VC setting.

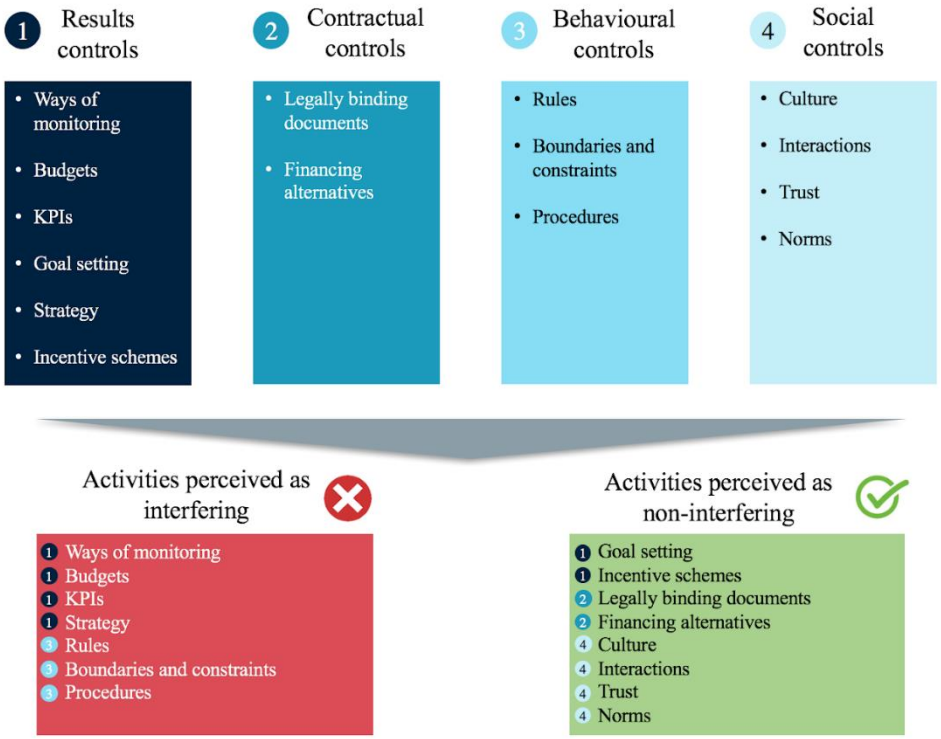

Figure 5: Classifying Bedford & Ditillos (2021) control forms and activities on the basis of perceived operational interference

5.4 Conclusion

The paper has three main findings in regard to how VC firms work with MCS in their portfolio companies and how they use it to manage the tension between control and innovation in relation to their portfolio companies.

Firstly, we find that innovation in a VC context is tied to individuals and their capabilities, rather than technological assets. Consequently, it is important for VC firms to respect the founders' entrepreneurial freedom, and also to be perceived as founder friendly. This explains the neglect to form or shape the portfolio companies' MCS as indicated by previous research (Meyssonnier, 2015; Granlund & Taipaleenmaki, 2005). Secondly, in order to understand the utilisation of control activities in their MCS, we suggest a developed version of the Bedford & Ditillo (2021) framework, with emphasis on perceived interference of each control activity. Our research indicates that the level of perceived operational interference

which a control activity entails, is the most important variable deciding prioritisation and utilisation between the control activities. Future research in the domain of MCS in a VC setting should therefore have its starting point in distinguishing perceived interfering control activities with perceived non-interfering, rather than investigating through the lense of a framework which separates control activities on the basis of activity form, which the Bedford & Ditillo (2021) framework do. Thirdly, our findings nuance the old research domain (see e.g., Rockness & Shields, 1984; Brownell, 1985; Birnberg, 1988; Abernethy & Brownell, 1997) and finds that accounting-based MCS in a VC-setting does not in itself hinder innovation, instead innovation is hindered when the founders perceive that they are being disturbed. In addition, our findings are partly in line with Davila & Wouters (2004) who found that by shifting away from traditional costing models, more time could be freed out and spent on R&D activities. Lastly, our findings are partly in line with Christner & Strömsten (2015) on the note that accounting-based MCS can work as both enabling and controlling. Furthermore, we find that the control forms in the Bedford & Ditillo (2021) framework complement each other and together add up. *Social* and *contractual controls* play an important role, and their heavy utilisation is explained by the fact that most of these activities naturally are perceived as non-interfering or are easy to disguise as such, which is the VC firms' objective when achieving control.

In addition to the academic contribution, our findings can be practically helpful for VC firms as our results give guidance for why they operate in the manner that they do and how they can solve problems. Our findings provide VC firms with a tool on how they can assert control on their portfolio companies, without the portfolio company losing its innovative edge. According to our understanding, it is sometimes not clear whether the VC firms actually reason around how they operate in order to reach their objective of achieving control (for example how they disguise control activities). We therefore hope that this paper can provide some clarification for VC firms, enabling them to concretisise their control activities and its implications. From the founder's perspective, our paper provides an understanding on how VC firms operate, and the potential loss of control through entering a partnership with a VC firm. This could potentially be helpful in order to not give up more control than they think or want to do, in the event of a VC entry.

On a final note, VC firms are hard to categorise; most of the companies interviewed for this study had a wide range of equity tickets and ownership stake in their portfolio companies. The investment process is mostly done on an ad-hoc basis, evaluating each opportunity on a case-by-case basis often going by gut feeling. Consequently, how control forms are utilised differs widely. The empirical analysis should be seen as indications of the industry's accumulated thought process rather than straight facts, this was the goal of the study, and we believe that our findings can be leveraged in future research to gather a deepened understanding of the unexplored and interesting universe of VC and MCS. Furthermore, this study has investigated MCS and innovation from a principal-agent perspective in order to answer our research questions. Hence, we have interviewed VC firms rather than the portfolio companies. Interviewing the portfolio companies' founders would add another perspective and perhaps

result in alternate findings, which is why we suggest that future research include the founders' perspective, and in particular how they view perceived interference of control activities. This would help to form a more comprehensive picture of the VC universe as a whole.

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7. Appendix

7.1 Interview guide

The first round of interviews were rather standardised and followed an interview guide as follows. Later-stage interviews became more unstructured and took different paths depending on objective, however under influence from the interview guide. Note that wording for the control forms were not communicated during the interviews but rather was there for our sake in order to ensure an adequate interview structure.

Initial background questions

- Short introduction to the company (AUM/typical equity ticket etc.)
- Describe your investment philosophy
- Are you niched towards a specific industry or another type of niche?
- Describe a typical portfolio company

Questions regarding innovation

- When you invest in new companies, how do you reason regarding the time aspect? Do you push the founders to take a quantum jump, or would you rather slow them down to play it safe, and be able to produce better forecasts for the company's future?
- What is innovation for you? New products, business models etc. or how would you define it?
- How important is the innovation aspect when you are prospecting new investments?
- Do you work with portfolio companies to promote innovation? Any structural approach in this matter?
- Do you work with portfolio companies in any way you can see affects innovation, with the goal to achieve better control?
- How do you think your entry affects innovation, given that the founders now become more controlled and influenced by you? How engaged are you operationally?

Questions regarding MCS utilisation

Contractual controls

- How do you align the founders goals with yours, which necessarily do not have to be the same?
- Do you work with contracts in the investment process in order to achieve control? For example, incremental investments, earn-outs, etc.?
- Do you think this is important to counteract any potential moral hazard issue, that you and the founder want to go in different directions?

Result controls

- How do you enable people to be innovative whilst at the same time steering them?
- What about goal setting, stretched targets etc.?
- How do you measure and how do you follow up on what you measure?
- Is it important for you that a good supervising framework including KPIs, budgets etc. is in place when evaluating an investment opportunity?
- If such a system is not present, but you still decide to make the investment, do you then work together with the portfolio company to develop it?
- How much time do you spend operationally to supervise your portfolio companies through monitoring financial numbers, do you engage in budget creation, or is your role more strategic overlooking? What is your view?

Behavioural controls

- How close contact do you have with the portfolio companies? Weekly, monthly etc.?
- Do you limit the portfolio companies in any strategic way?
- Do you implement new rules and policies in your portfolio companies prior to an investment?
- How much do you go in and micromanage in this way to shape behaviour?

Social controls

- How do you work with culture in portfolio companies?
- Do you do anything to create norms and cohesion to strengthen collaboration between you and the portfolio company?
- Is it important for you to trust the founder and his/her agenda, or do you rather trust other control mechanisms to stop any plans that deviate from your commonly agreed agenda?
- Do you work actively to change or create norms in the portfolio companies, if so in which way and why?
- Do you host workshops or similar to strengthen group cohesion and in order to let portfolio company employees to meet you?
- How important is social interaction between you and the portfolio companies?
- Do you usually hire a new CEO in order to lead the company in your preferred way?

Other questions

- Do you see a dilemma between steering and controlling the portfolio companies whilst still letting them be innovative?
- What kind of control, exercised on your portfolio companies, do you think is the most important for your firm?