

CORPORATE GOVERNANCE: UNDERSTANDING IMPORTANT CONTINGENCIES*

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Abstract

The objective of this paper is to explore important contingencies for boards and governance designs. The paper is made in a setting where governance in SMEs in transition economies is to be developed, and knowledge from advanced market economies constitutes the framework to be built on. The core of the paper is the presentation of six groups of important contextual variables that must be analyzed and understood when corporate governance systems shall be developed. The framework presented in the paper includes understanding the perspectives of both internal and external actors in the corporate governance process, and that the design of a governance system will include issues related the board working style as well as the board members.

Key words: Board roles, corporate governance, board context, contingency theory

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1. Governance of SMEs in Advanced Market and Transition Economies

The theme of this expert meeting is “Good governance for SMEs”. One of the questions the meeting raises is what can we learn from advanced market economies when we address small and medium sized enterprises in transition economies? In this article I will present a framework of corporate governance that is developed in advanced market economies. The framework has its origin from the corporate governance discussion and research in USA. Main corporate governance concepts are presented and discussed. The framework also presents some of the shortcomings in the ongoing corporate governance discussions in advanced market economies. The framework has a contingency approach indicating that there is not one best way to design a governance system, but also that not all ways are equally good. The design of a governance system must consider the actors involved and the context for which the system is designed. Important contextual factors are the national and cultural setting, and the size of the firms. The framework also indicates that a corporate governance design must include considerations about actual board behaviour. One of the challenges in this expert meeting would be to apply this framework in

a context of SMEs in transition economies. Corporate governance and in particular the board of directors can be perceived to be particularly important when countries are in transition (Judge, Naomova and Koutzevol 2003, McCarthy and Puffer 2003). Transition economies governance systems have been shown to be practically non-existent. The relevance of known governance regimes in advanced market economies is likely to be challenged. Governance systems in transition economies will need to be designed so they reflect and meet the countries historical and cultural setting (Peng, Buck and Filatotchev 2003, Puffer and McCarthy 2003). One of the problems in the present corporate governance debate is the lack of understanding of informal sources of corporate governance. The present corporate governance debate has been shaped by waves of shareholder and investor activism guided by theoretical development in financial economics. Theoretical modelling from financial economics have only to limited extent been able to grasp importance of changing stakes and power of various stakeholders, and the informal sources in corporate governance that vary across cultures and contextual settings. The framework that is presented below will hopefully help meet some of these shortcomings. The framework may include societal objectives related to en-

trepreneurship and corporate social responsibility in a culture where the institutional context for corporate governance more or less is missing. In this article I make a review of corporate governance practices at a micro level in advanced market economies. During the meeting we will explore the situation at the micro-level in transition economies, how SMEs understand corporate governance, what their problems are and what governments and non-governmental organizations can do to help them. The rest of the paper proceeds in four sections. In the coming section the corporate governance debate in advanced market economies is presented. A contingency approach to boards and governance imply an understanding of actors and context. In this section various actors are presented through an introduction of the various waves of shareholder activism. Corporate governance is more than shareholders monitoring management. The section leads to a presentation of various board roles depending on the various perspectives and focus represented by various actors and theories used in this debate. The six board roles presented are output control, behavioural control, strategic control, networking roles, advisory roles and strategic leadership roles. In the following section six groups of contextual factors are presented. While most of the research on boards and governance is originated with background in large established corporations in USA with institutional ownership, I will in this section present that and how national and cultural setting, industry and environmental factors, ownership dispersion and type, firm size and firms life cycle, and characteristics of the management will influence corporate governance design decisions. It is of crucial importance to understand the actors and context in transition economies when designing governance systems in these countries.

Then follows a section where some of the basic governance parameters are positioned. The most used parameters relate to board members and composition, and to board structures and working style. It is not enough to assume that boards are performing according to theory based assumptions. That is a myth. Actual board role performance is a result of both the choice of board members and on the boards' working style. The main corporate governance design has traditionally been board composition, and most research on boards and governance has been about the number of board members, insider/outsider ratio and CEO duality. The attention has only recently been directed to develop and formalize structures that regulate and direct the perspectives and influences of the various actors to achieve value creation. Through the final section owners, managers, directors and policy makers in transition economies are challenged to reflect on the contingencies that are the most important in their setting in countries of transition. There is not one best way of governance, and actors in transition economies should only with great caution adapt to the codes of corpo-

rate governance that have been developed in market economies. This reflection is also often missing in advanced market economies. The challenge to design and develop governance systems in transition economies is of particular importance and urgency as even informal systems and rules of the game seem to be missing in these countries.

2. The Corporate Governance Debate and Board Roles in Advanced Market Economies

Definition of corporate governance:

The interaction among internal stakeholders, external stakeholders and the board members in directing a firm for value creation.

Any definition of corporate governance will be biased. Advanced market economies led by waves of shareholder activism from USA during the recent 15 years have been dominated by investor biased definitions supported by agency theory. Investors have been principals and the firms or their management, including the boards, have been the agents. This definition has its origin in the separation of ownership and leadership of firms that was discussed in the early 1930's (Berle and Means 1932). In large corporations with large ownership dispersions, owners were most often too many and individually too small to be able to control the corporations. The corporate control or governance discussion was about this situation, and a board of director was seen as a way to overcome or meet these governance challenges. In USA the need for boards to monitor management to avoid managerial mal- or misbehaviour and opportunism was clearly evidenced in the 1980's. Corporate managers used their power to circumvent shareholders' interest and allowed themselves skyrocketing wage increases and various other perks, exemplified through company jets. The markets for corporate control were circumvented through various anti-takeover defences as shark repellents, poison pills, greenmail, white knights, etc.

Waves of shareholder activism. The first wave of shareholder activism was lead by major long-term institutional investors such as Dale Hansson in California Public Employees Retirement System (CalPERS). Guided by agency theory they fought for boards and board members that were sufficient independent to resist managerial dominance or hegemony. Boards should not only be rubber-stamps of decisions made by management, or ornaments on the corporate Christmas tree. The boards should set objectives, ask discerning questions and hire, fire and compensate the CEO. The boards' role should be to create value for shareholders through value creation in the firm. In UK this view was supported by the Cadbury Commission (The Financial Aspects of Corporate Governance 1992). Led by Sir Adrian Cadbury this commission developed a semi-

nal code of best practices in 1992. Suggestions following this wave were to separate the positions of the chairperson and the CEO and to have a majority of independent directors.

A second wave of shareholder activism followed the trends of globalization, disappearance of distances, information technology and rapid changes in the new economy. Firms became increasingly global, and owners became faceless. Large corporations were listed on stock exchanges around the world, and private persons invested in stock saving funds administered by portfolio managers being evaluated on quarterly earnings. Attention to market prices replaced the attention to dividends. These impatient owners or portfolio managers also prescribed medicines with roots in agency theory and financial economics. Managerial incentives should be aligned to the shareholders' interests, and managers became residual claimants through shares or stock options. Stock Exchanges and various investor groups continued to develop corporate governance codes, and corporate governance was defined as monitoring by owners.

An alternative trend in corporate governance got considerable wind in the sails as a result of the large corporate scandals. The crises such as those at Enron, World.Com, Tyco, etc clearly showed the importance of other stakeholders than the shareholders. Employees, customers, supplier and local societies suffered severed losses due to managers driven by the possibilities to create personal values through dramatical increases in market prices of their shares (Kochan 2003). The broader perspective of corporate governance was reintroduced, and corporations were reminded of their societal responsibility (CSR) of national as well as international bodies as the United Nations and the World Bank. Suggestions to meet the problems included CSR reporting and the introduction of various stakeholder representatives on boards, for example employee directors. The U.S. government went so far as to introduce the Sarbanes-Oxley Act. In USA it is very rare that that federal laws are made to regulate corporate activities. Some groups of shareholders and investors became gradually unhappy with the codes and concepts introduced by the previous waves of shareholder activism. These were groups of blockholders, individual investors and other owners that wanted to contribute to value creation through working in the boards of the corporations. Most firms, and in particular small and medium-sized enterprises, are dominated by such owners, and among them we find family firms and entrepreneurial firms. These groups of owners may have other objectives for their involvement and ownership in firms than value creation through dividends or earnings. Their involvements may also be of strategic nature and be related to value creation in other arenas.

External versus internal governance perspectives. The above waves or trends in the corpo-

rate governance debate all have an external stakeholder perspective where the firm is considered as an agent of external stakeholders, and a main role of the board has been to control or monitor the management on behalf of the external stakeholders. The agency theory that is behind this monitoring role have, however, been criticized from various perspectives. One critic is about the underlying assumption of managerial opportunism. Other critics are that the focus is taken away from the firm to external stakeholders. The question has been what is best for the stakeholders rather than what is best for the firm. There has been too much emphasis on the board's oversight or control roles at the expense of alternative board roles (Daily, Dalton and Cannella 2003). Stewardship theory has gained foothold among many management scholars, and also in the practical life in USA (Davis, Schoormann and Donaldson 1997, Stiles and Taylor 2001). While agency theory builds on the assumption of managerial opportunism, which leads to the needs for boards being active in controlling and monitoring, the stewardship assumes that managers in general should be considered as good stewards. Stewardship theory will promote board roles as collaboration and mentoring, and boards should thus also be active in the strategy formation and strategy implementation phases. The agency theory implementations in corporate governance have mostly tried to reduce the agency costs related to opportunistic behaviour of the management. Less attention has been given to maximize value creation. Corporate governance systems should rather be designed to maximize principals' interests rather than merely minimize agency costs. The forces wanting to keep the CEO duality in U.S. boards use stewardship theory as an argument. The argument is that a corporation is better served with one rather than two persons on the top. Resource dependence theory was for many years a dominant approach in sociology, strategy and organisation theory to motivate the existence of active boards (Pfeffer and Salancik 1978). The board was considered to be a boundary spanner that could help the corporation acquire important resources from the environment, and thus reduce the corporation's dependencies of external stakeholders or threats. Important board roles from this perspective are that of networking, door-opening, legitimacy and communication in inter-organisational relations. Cooptation is a main board strategy derived from resource dependence theory. Cooptation can be defined as the process where elements in the environment are taken into the leadership or policy formulation body in an organization to guard it against threats against its stability and existence. Cooptation increases the possibility to receive future support from the organization being co-opted.

The resource-based view of the firm is more internally focused than the resource dependence theory (Barney 1991). Through a resource-based view of the firm, the board members are not only resources

through their networks, but also through the competency they have. Board members will be evaluated based on their contribution to sustainable competitive advantage through their professional and personal qualifications. An internal focus of firm resource will emphasize the board's role in providing various kinds of advice to the management. Transaction cost reasoning will help define if such resources

should be among the board members rather than in the hierarchy or the market (Williamson 1985).

The various waves and perspectives in the corporate governance discussion in advanced market economies can be summarized with respect to internal versus external perspectives, and with respect to internal, external or strategic focus. In table 1 such a summary is presented with respect to board roles.

Table 1. Perspectives and focus of board roles

	Firm external perspective External stakeholder Control	Firm internal perspective Internal stakeholders Service
External focus	Output control, Financial control Agency theory, Stakeholder theory Short term institutional investors Value creation for external stakeholders Value distribution: Earnings, CSR	Networking, lobbying, legitimating, communication, Resource dependence theory Social network theory, interlocking directorates and class hegemony Value creation through external actors
Internal focus	Behavioural control, Operational control Agency theory, Long term institutional investors, Value creation in firm, Dividends	Advise and counsel, Resource based view of the firm, Institutional theory and managerial hegemony, Value creation through directors
Strategic focus	Strategic control, Ratification and control, Agency theory, legal view and property rights, Individual investors and blockholders, Corporate ownership and family firms, Value creation through firm	Strategic leadership, Initiation and implementation, Stewardship theory Value creation through collaboration and mentorship in the board

Six distinct board roles are displayed in the table. The presentation in the table can also help sort concepts used in the board role literature. Three of the roles can be summarized as what most often is called control roles. These are the roles stemming from an external stakeholder perspective. They correspond to what the control role concepts of Hillman and Dalziel (2003) and Johnson, Daily and Ellstrand (1996). The remaining three roles can be labelled service roles (Hillman and Dalziel 2003), and they have an internal stakeholder perspective. The roles with external focus are the output control and networking and legitimacy roles. The networking and legitimacy is what Johnson, Daily and Ellstrand (1996) calls the resource dependence role. The roles with internal focus are the behavioural control and the advisory roles. The roles with strategic focus are those of strategic control and those of strategic leadership (Zahra and Pearce 1989). Johnson, Daily and Ellstrand (1996) combine advice and strategic leadership in what they call the service role. The service role of Zahra and Pearce (1989) includes the advisory and networking roles.

3. A Contingency Perspective on Corporate Governance

The corporate governance discussion has to a large extent been shaped by the situation and development in USA and UK. Most of the discussion has been about if it is best for a firm to have more outside board members, or if the CEO also should be the board chairperson. Less attention has been given to "What ensemble of institutions best situates a nation for economic growth in a global, post-industrial, information-based economy?" (Davies and Useem,

2002: 233). Since 1995 we have seen a fast growing number of studies and publications on comparative governance systems, governance in different countries, and governance under various systems, e.g. economies in transitions. Recent corporate scandals also lead scholars to use alternative perspectives in understanding governance and search for alternative organizational forms. Stakeholder perspectives on corporate governance have received increased attention (Blair 1995, Huse and Rindova 2001, Wright et al 2003). This stream of research represents a quest for alternative approaches, theories or even paradigms in corporate governance research. Many of the researchers in this stream are very critical to the shareholder value paradigm that has dominated mainstream research and in particular the contributions coming from financial economic.

A contingency perspective to understanding boards and governance will have the starting point that there is not one best way of designing boards and governance systems, but that not all ways are equally good. When designing boards and governance systems we must take into account the actors and the context. The actors are not only the board members, but also the whole range of internal and external stakeholders or actors. We earlier defined corporate governance to be the interactions among various actors. They have various stakes and power in a corporation. Their stakes relate to the value creation and distribution of value creation of a corporation. Their nature and intensity of their power will vary with contextual factors, as will their knowledge and use of various governance mechanisms. The contextual factors being the most often identified in corporate governance research are: national, geographical and cultural differences; industry and envi-

ronment of the corporation; variations in ownership dispersion and types; differences in firm size; life cycle variations, including the importance of crises and the configuration of corporate resources; CEO tenure, attributes and background.

National, geographic and cultural differences. Aguilera and Jackson (2003) developed a model to describe and explain variations in corporate governance among advanced market economies. The model identifies the social relations and institutional arrangements that shape who controls corporations, what interests corporations serve, and the allocation of rights and responsibilities among corporate stakeholders. Most international comparisons of corporate governance systems are stylised comparisons of the Anglo-American and the Continental European systems. The Anglo-American represents the dispersed ownership, active markets for corporate control and flexible labour markets. The Continental European system represents long-term debt financing, ownership by large blockholders, weak markets for corporate control, and rigid labour markets. Aguilera and Jackson claim that this classification only partially fits the variations within Europe including Eastern Europe, East-Asian countries, and multinational corporations. Their model is based on analysis of three stakeholder groups; capital, labour and management, and that corporate governance designs and conceptualisations should be embedded in the social context that exists.

Industry and industrial environment are among the factors that generally are supposed to influence corporate governance. The industrial environment is often characterized through heterogeneity, dynamism, hostility and technological opportunities. When the environment is complex or characterized by heterogeneity there will normally be needs for a broad scope of knowledge in the firm and among board members. Diversity among board members may be important, and advice will be a main role for the board. In environments characterized by dynamism and rapid changes fast decision-making may be needed. Board members may be needed that can rapidly understand a situation and ratify suggestions presented by the management. Board members with the same background and cognitive framework as the CEO may better meet such requirements than persons thinking in alternative ways. Homogeneity among board members may be preferable to diversity when the industrial environment is characterized by dynamism. Hostility relates to both the competitive climate as to the relations to various stakeholders, for example municipalities, etc. A fierce or hostile competition may require participative board members that are involved in strategic leadership, while a hostile attitude from other stakeholders may benefit from board members that can contribute to making the environment friendlier. The legitimacy role will thus be important. A corporation in industrial environment characterized by techno-

logical opportunities may in particular benefit from entrepreneurial orientation and the creativity of board members. This may include an innovative use of the network of the board members. There are often correlations between the industry of a corporation and its industrial environment, but industries can also be described in terms of for example technological sophistication, knowledge intensity, capital intensity, stakeholder sensitivity and international orientation. Governance in emerging industries may also vary from governance in established industries. Some industries will have many firms that can be compared, for example hotels, food production, construction, etc, while other industries, for example those characterized by technological sophistication and knowledge intensity, have firms that may be difficult to compare. In the first group it may be possible for board members to rely on output control, while behavioural control may be more needed in the second group. Governance systems may vary significantly between knowledge intensive firms and capital intensive firms. Some of these differences may also relate to variations in property rights. Partnerships in consultancies and the faculty's role in university boards may resemble some of these differences. In stakeholder sensitive industries there may be particular emphasis on transparency and accountability, and boards in such industries will more than boards in other industries related to various stakeholder concerns such as corporate social responsibility. This is for example the case in high polluting industries, the energy sector, health care sector etc.

Ownership. Variation in ownership has traditionally been studied in relations to ownership dispersion. It is, however, also important to understand different kinds of ownership (Pedersen and Thomsen 2003). Both type and dispersion of ownership highly vary across countries and across different industries. This article started by presenting the corporate governance debate in relation to various types of ownership, including institutional ownership. Institutional owners are often reluctant to have a direct representation on boards due to simultaneous involvements in more companies that may have competitive interests. Individual, corporate, state and family owners will more often have a direct representation on boards (Gedaljovik and Shapiro 1998). The role of the board may, however, vary across each of these five kinds of owners. For example among corporate ownership we find cross ownership, parent-subsidiary relations, strategic ownership, and friendly and hostile ownership situations, and in some situations inter-organisational communication through interlocking directorates may be a main role of boards. In family firms a family council often exist, and the existence of family councils may effect the role of the other governance bodies. Executive ownership will also influence boards and governance, but it is often considered to be a mean motivated by agency theory rather than a contingency. Zahra, Neubaum and Huse

(2000) also explored the role of different kinds of institutional ownership. They differentiated between pressure sensitive institutions, pressure resistant institutions, and pressure indeterminate institutions. The time perspectives of the ownership of these investors usually vary, and the type of ownership influences both the direction and kind of involvement in the boards. Pressure resistant investors have a long-term perspective of their ownership, and pressure indeterminate investors' perspectives are often short term. Pressure indeterminate institutional investors are often brokerage houses and investment counsellors. Pressure sensitive institutional investors are investor having business relationships with the firm. Their success and profitability will often depend on a good and strong relationship with the firm in which they invest, and thus in case of conflict they will avoid challenging the management and rather sell their stock. Banks and insurance companies are often pressure sensitive institutional investors. Board roles in firms dominated by pressure sensitive institutional investors will rather be service oriented than control oriented. Pressure resistant institutional investors do not have any close business relationships to the firm, and thus they are also expected to be independent of management. Such investors usually include public pension funds, mutual funds and foundations. These owners will to a large extent ask discerning questions and may vote in a different way than managers on strategic issues. Various kinds of ownership may also play an important role in small firms. In such firms ownership can often be seen as a consequence of an entrepreneur's need to finance growth, and most small firms are characterized by concentrated ownership where the CEO and his/her family has a major ownership stake. Major ownership issues in small firms are thus related to family business discussions, and that of financing growth. The introduction of external equity capital in small firms often considered not desirable, as the entrepreneur, family or small business owner-manager may lose control of the business. New equity or risk capital often comes from formal and informal venture capital providers. The formal venture capital providers, the venture capital firms, may have other strategies and ways to governance their investments than the informal venture capital providers, the business angels. Common for both groups is that they most often have active involvement in boards, and that boards in small firms are becoming considerably more active with the existence of such venture capital providers (Gabrielsson and Huse 2002). Clearly defined subgroups that have distinct contributions with respect to boards and governance can be identified both among venture capital investment firms and among business angels.

Firm size. Some authors consider firm size to be the contextual factor having the largest impact on boards and governance. Most of the literature and research on boards is on firms in large corporations,

but there is now a growing attention on boards in SMEs both in research and in practice (Huse 2000). Boards in small firms are often considered to be "aunt" board that nobody plan will have any role other than the formal role given by law. As mentioned above, there are various kinds of small firms, and they are often characterized by ownership concentration, and that there may be other values of importance for the shareholders than return. Small firms will often be characterized by lack of basic resources, and the various service roles will thus often be higher valued in small firms than large firms. The service roles are enforced by the empowerment of boards in such firms, as it will to a large degree be based on the CEOs trust in the board members. The board members in small firms are often a pool of helpers, playing the role of discussing partner, crying shoulders and sources for advice in decision-making (Johannisson and Huse 2000). This pool of helper may include "professional" board members and business angels. The traditional shareholder initiated control role may be of less importance as the manager often also is the main owner. However, there are certain forces also in small firms that lead to an emphasis on the control roles. In small firms other stakeholders than shareholders may play important roles (Huse 1998). Banks, customer, suppliers, employees and local societies may also be important actors with both stakes and power in the firms, and significant evidence exist in how banks empowers boards with external directors. Markets for control will vary between small and large firms, and the substitution effects arguments will then predict an emphasis on the control of the board. The control role of external stakeholders is often difficult in small firms as reliable information and accounting practices may be lacking, which causes significant information asymmetry. Small firms often lack resources to prepare reliable information about the firm, and accounting and management systems often rely on one person, the CEO, and the prime source of data storage and processing is the head of the CEO. Incentives for board membership in small and large firms may also vary. In large firms monetary awards and status are included, while in small firms it is most often only hard work and a gesture to help a small business manager, often a friend, needing help.

Firm life cycle. Board roles will vary in times of crisis and in normal times. Many scholars have carefully studied the board's role in situation of crises (Lorsch and MacIver 1989, Mace 1971). There are various kinds of crises, for example those triggered by internal events versus external events, gradual versus sudden crises, economic versus reliance crises, etc. The various kinds of crises change the stakes, power and activities of various actors, and there will be pressures to change board roles, for example will banks and other stakeholders in times of financial distress often take over the roles normally performed by shareholders. Fewer studies

have been done about the role of boards in different life cycle phases, but a growing body of literature shows how the theoretical rationale for boards vary with the life cycle stage of the firm (Huse 1998, Lynall, Golden and Hillman 2003). The life cycle stages of a firm typically consist of an entrepreneurial stage, a collectivity stage, a formalisation and control stage and an elaboration of structure stage. Lynall et al (2003) showed how board role expectations varied in the various stages, and that board composition would reflect the relative power of internal and external stakeholders at the time of board formation. The following propositions were presented by Lynall et al: i) Boards established in the entrepreneurial stage will reflect the social network of the CEO or the external financier depending on who has the dominant power, ii) board established in the collectivity stage will reflect the resource needs of the firm if the CEO has the dominant power, but the requirement of the institutional environment if the external financier has the dominant power, iii) boards established in the formalization and control stage will reflect the resource needs of the firm if the CEO has the dominant power, but it will reflect an agency perspective if external financiers have the dominant power. The finally propose that board composition should be changed according to the life cycle phase of the firm.

CEO tenure and characteristics. Board roles will vary depending on attributes of the CEO, for example CEO tenure, ownership and competence. In an article on the dynamics of CEO-board relationships Shen (2003) shows how boards with a newly recruited CEO, should focus on supporting and mentoring the CEO. Research on executive leadership shows that CEOs, when recently recruited spent considerable time in trying to understand and get to know the organisation. They need to learn and adjust to their new role and how to work with the board, the other members of the management team and important stakeholders. This adjustment situation is greater for externally recruited CEOs than for those being internally recruited. Shen argues that the board in this situation based on stewardship theory should focus a mentoring approach. However, observation is that CEO power increases over time. New CEOs normally needs a few years to acquire the needed task knowledge before they can take major actions to reshape the organisation. However, over time CEOs tend to get more power, and once CEOs has exceeded the expectations of the board and important stakeholder, they may be more susceptible to opportunism. The board's role should then change from mentoring to monitoring. Scholars thus suggest that a new CEO should have a "honeymoon". Furthermore, boards will relate to CEOs representing majority ownership, for example through a family firm, than when the CEO is independent of owners. The discussion of separation of ownership and control (Berle and Means 1932, Fama and Jensen 1983) relates to

the situation when the CEO only have a minor ownership stake. Executive ownership is also one of the topics being most studied in corporate governance. When the CEO also is an important owner, the board's role will to a large degree be the service roles of advice and networking activities.

4. Myths and Realities: Understanding Actual Board Behaviour

Research on boards has, as above indicated, been dominated by a tradition in which board composition is related to corporate financial performance (Johnson et al 1996, Pettigrew 1992, Zahra and Pearce 1989), and mainstream research has been heavily influenced by a research tradition from financial economics and theories treating the board as a "black box". The various roles are reflected as theoretical board role expectations, and actual board task performance is rarely measured. Even though Zahra and Pearce (1989) also showed that there was a need to use mid-range theories including measures of a set of board attributes going beyond board composition, this is hardly done. Johnson et al (1996) conclude that it is difficult to find relationships between board composition and financial performance in any of these traditions. They indicate that there may exist a negative relation between the number of board members and financial performance, and they argue for reintroducing the inside director. For future research they suggest that boards also should be seen as social constructions. Forbes and Milliken (1999) present the board as a social construction and employ cognitive theories to understand boards. They see the need to open the black box, and they present a model of board processes. They argue that boards should be understood through attributes of board composition and its members, the board's working style, and the board level outcomes. They align attributes to boards as any other decision-making group, including preparations and the use of knowledge and skills, cognitive conflicts, effort norms and cognitive conflicts. Board task performance is introduced as an alternative efficiency criterion. While Forbes and Milliken argue for understanding and measuring processes inside the boardroom, Pettigrew (1992) argues for considering the board as an open system, and that studies of board roles should not be separated from studies of power in institution and society, or from studies of composition and attributes of top management teams. Various research directions of managerial elites should be integrated, and we must understand the dynamism in relations inside and outside the boardroom. Processes both inside and outside the boardroom are necessary to explore when understanding boards of directors. Figure 1 combines the initial corporate governance definition, the board role discussions, contingency theory and the suggestions of Forbes and Milliken (1999) to open the "black box", see the board as an open sys-

tem (Pettigrew 1992), and to study various intermediate links in order to understand the governance – financial performance relations (Zahra and Pearce 1989). The governance – performance are not static, but dynamic (Huse 1998, 2000). The dynamism is illustrated by some of iterative arrows in the figure. There are four main groups of concepts in the model (Forbes and Milliken 1999): a) Board composition, b) board working style, c) board level outcome, and d) corporate level outcome. The starting point in the model, however, is not the board members or board composition. The starting point is the definition of corporate governance as it was presented in an earlier section: “the interactions among internal stakeholders, external stakeholders and the board in directing a corporation to create value”. This means that the interactions including the cluster of concepts related to trust, emotions and processes inside and outside the boardroom is in the core of understanding governance. This is possibly the most dynamic part of the model, and learning processes are of high importance. Stakeholders have difference emphasis and expectations with respect to board roles, and it is

the interaction between external stakeholder, internal stakeholders and the board that will direct the criteria for board member selection. The main board and governance design parameters at the micro level are board composition and formal board structures. These parameters should be deeply embedded in the contingencies presented above.

Board composition. Board members have several characteristics, but the traditional board member-parameters like insider/outsider ratio, CEO duality and number of board members are by far representative for board compositional attributes. The traditional parameters have hardly got any empirical support (Daily et al 2003). The theoretical arguments about independence, incentives and competence are not reflected properly. More measures of competence, experiences, background and motivation should be considered for each director, for the board as a group, and for the board relative to internal and external stakeholders. Various diversity considerations should also be included as design parameters.

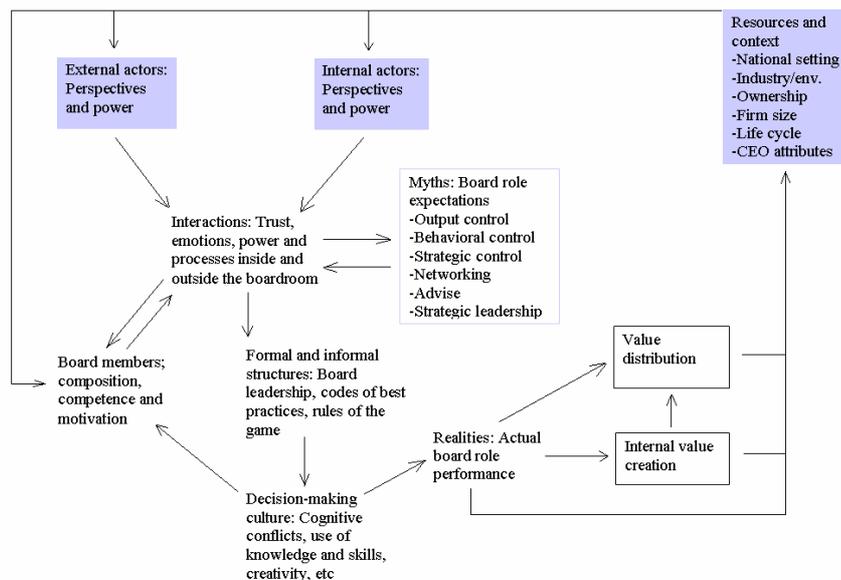


Figure 1. Corporate governance: a framework

Board working style. The contributions of the board members, the effects of board composition and the attributes of the board members depend again on the processes inside and outside the boardroom. At least three groups of board working style variables should be identified: 1) Interactions inside and outside the boardroom, 2) formal and informal structures including board leadership, and 3) the decision-making culture in the board. The board working style parameter is the structuring of the board working style and leadership. Such parameters are found in several of the corporate governance codes evolving from the present debate, and they include regular board evaluation, board development sessions, work

descriptions for the CEO, board instruction, the development of committees, guidelines for accountability and transparency, and ethical codes.

Board level outcome. There is often a wide gap between theoretically derived board role expectations, and the extent to which these are performed in empirical studies (see for example Zahra and Pearce 1989, Johnson et al 1996). Figure 1 illustrates this gap between board role expectations and board role performance. Mace (1971) clearly presented the gap between formal board role expectations and actual board performance. Mace presented that it was a myth that boards were setting objectives, asking discerning questions and hired/fired/remunerated

CEOs. In reality there were so many processes inside and outside the boardroom, and unwritten rules of the game that made actual board contribute in alternative ways. He found that there was a managerial hegemony giving the board in practice the role as a council or a cabinet for the CEO, a disciplinary role, and that boards acted in situation of crises. This understanding of differences in board role expectations and actual board task performance should be included in board role studies, and the model indicates that theories leading to board task performance will have large predictive power than general board expectation theories.

Value creation and firm level outcome. In figure 1 a distinction between internal and external value creation is suggested. Corporate entrepreneurship is suggested as a starting point to define internal value creation. Internal value creation is in the model mediating the link between board task performance and external value creation. External value creation is also about value distribution. In our corporate governance definition we let the question about value creation for whom is open. The firm was seen as a nexus of relationships, and no stakeholders were in the definition given priority before others. The boards' role was also to balance the interest of various stakeholders. That makes it important also to identify how a firm can create value for various stakeholders, and various corporate performance measures may relate to different stakeholder groups.

5. Governance of SMEs in Transition Economies

In this paper we have reviewed core contingencies in corporate governance designs in market economies. During this expert meeting we will review current corporate practices in advanced market economies and countries in transition in the UNECE region. We will also share experiences among institutions and academics dealing with this issue. My approach has been to look at the situation at the micro level. How do the SMEs understand corporate governance, what is their problem and what governments and non-governmental institutions can do to help them? During the expert meeting we will also look at the situation from a macro level. The review addresses the need to understand the perspectives of both internal and external actors in the corporate governance process. But who should be considered internal actors and who are external actors? This question is not always easy to answer, but must be discussed in relation to what or whom they are internal or external (Huse 2000). Employees for example may be internal in relation to the firm, but they may be external in relation to management. Family members may be internal to the family, but external to the firm. And owners can in many cases be considered as internal in relation to corporate decision-making, but external in relation to managerial decision-

making. Furthermore, is an actor external if it has close relationships with internal actors? By asking these questions I indicate the need for a context-based definition of categories of various actors in the corporate governance system of an enterprise. The design of a governance system must consequently consider the actors involved and the context for which the system is designed. The review also addresses the need to include issues related the board working style as well to the board members in the design of governance systems. Formal policies and regulations may be necessary but is not sufficient for creating a culture for good corporate governance among managers, owners and other stakeholders. Well-developed enterprise governance requires that all actors in the corporate governance system recognize and understand their roles and it is consequently the behaviours, decisions and activities of the participants that must be in focus. Good governance is an important element in developing a market economy and in promoting economic growth, especially in emerging and transitioning economies (Judge 2003, McCarthy 2003). SMEs may however be less likely to have resources to accomplish corporate governance developments, and SME managers may also run their companies as if it were only their stakes that were involved and satisfying own interest to the detriments of other main stakeholders and the company as a whole (Jones 1992, Markman 2001). This implies that there may be need for public education efforts to promote the understanding of principles of good governance in SMEs and to identify board members with diverse talents and experience, including women and others that often are excluded.

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