

# GOVERNANCE STRATEGY: TURNING GOVERNANCE INTO ACTION\*

SVEN-OLOF COLLIN, PROF

Department of Business Studies  
Kristianstad University  
S-291 88 Kristianstad  
Sweden

Phone + 46 44 20 31 19  
Fax: + 46 44 20 31 03  
E-mail: [Sven-Olof.Collin@e.hkr.se](mailto:Sven-Olof.Collin@e.hkr.se)

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**Abstract:** Corporate governance (CG) needs to acknowledge the intentional part of governance, where an actor of governance uses the set of corporate governance mechanisms in order to influence the agent to create a performance that will satisfy the interest of the principal. This paper offers a conception of this activity through the concept of governance strategy. The concept is derived within the context of agency theory and applied to two empirical organisations seldom investigated in CG research: the organisation of multinational corporations in a business group, and the organisation of a riding school in a democratic not-for-profit organisation.

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Corporate governance (CG) is a research theme that has rather intensely been on the research agenda for more than two decades. The intensity in research could partly be explained by the attention the subject has received in praxis, especially in the United States and especially concerning the governance problems of listed corporations with dispersed ownership structures. The effect of this orientation has been that CG research has (a) focused on large corporations characterised by dispersed and weak owners, presumed to be subject to opportunistic agents, and (b) adopted a strong nomothetic research approach, where one dependent variable is correlated with several independent variables. This orientation has led to an image of the principal as only one part of the system that constitutes the corporate governance of the corporation, on the same level of importance as the capital market, the managerial labour market, and the board of directors with regard to influence on the corporation and its management. This is therefore a view that approaches environmental determinism (Eisenhardt, 1989).

Less attention has been paid to CG in organisations such as the family firm, the state-controlled firm, the non-US-firm, and on networks of corporate power, i.e., business groups, that are so common in Europe and Asia. In these organisations, the owners, or rather, the principals of the organisation are stronger and have a larger impact on the organisation than do the dispersed owners of the large listed corporations. With these organisations and their CG in mind, a different picture of governance can be portrayed, while still using the knowledge created in CG research. This picture, as used in this paper, will stress the capacity and interest of the principal to engage in governance, thus approaching the other extreme theoretical position, that of strategic choice. It will here be termed *governance strategy*.

Corporate governance can be defined as a set of mechanisms that support the fulfilment of the will of the principal. This set consists of capital (be it equity or debt), managerial labour selected from the external or the internal managerial labour market, executive compensation, the board of directors, the strategy and structure of the organisation, the auditors, and the environment (cf. Schleifer & Vishny, 1997). In a context of environmental determinism, the aim of an investigation will be to find out to what extent one or more mechanisms can fulfil an assumed goal of the principal, such as profit or growth. At the other extreme, strategic choice, a more praxis-oriented view of CG appears. The proper question of this view is: To what extent can CG mechanisms be managed by an actor of governance, i.e., the principal? The answer to this question represents the governance strategy, which can be defined as the conscious plans and actions for designing single CG mechanisms and composing the mix of CG mechanisms, with the aim of disciplining and

enhancing the entrepreneurial capacity of the agent in order to make it possible for the organisation to satisfy the needs of the principal.

The aim of the paper is to indicate the relevance of the concept of governance strategy. This will be achieved by constructing a conceptual model, which will be applied to two distinct organisations, thereby illustrating and to a certain extent validating the governance strategy model.

In this respect, we follow the route of Karl Marx in his ‘Theses about Feuerbach’, that philosophers have been explaining the world, while the objective is to change it, i.e., to adopt a praxis orientation towards CG. A praxis orientation should not, however, be confused with a normative orientation, i.e., telling people which norms to assume and how to act. Aside from most of the criticism against normative approaches, only one argument should be sufficient to destroy any normative ambition in the field of CG: that it would be presumptuous at this level of conceptual development and empirical testing in the field of CG to make any claim of knowing the proper action for practitioners.

Praxis orientation is a more respectful approach towards reality and political action because scientific knowledge is used to indicate routes of action and considerations to be made, yet without suggesting any actual choice. Consequently, this paper adopts the praxis-oriented conception of CG, indicating how the scientific knowledge of CG can be used to turn governance into action.

Accordingly, we start by outlining the conceptual development of governance strategy (section 1), then apply it (in section 2) to two rather exotic organisations in CG research—a riding school organised as a democratic, not-for profit association (2.1) and a business group consisting of many international corporations (2.2), offering comparisons between the two (2.3), leading to conclusions (in section 3) about the governance strategy conception.

## **1. GOVERNANCE STRATEGY: THE MODEL**

Governance strategy is a praxis-oriented concept of corporate governance, implying the existence of an actor of governance capable of influencing single CG mechanisms and the mix of the mechanisms. This actor of governance is at the centre of the model of governance strategy (Figure 1), and will be termed, according to mainstream agency theory, the *principal*. Our point of departure is that it is possible for a principal to have a governance strategy, i.e., the principal can have conscious plans and actions for designing single CG mechanisms and composing the mix of CG mechanisms, with the aim of disciplining and enhancing the

entrepreneurial capacity of the managers in order to make it possible for them to satisfy the needs of the principal. Indeed, it has been shown by Demsetz & Lehn (1985) that part of the governance mechanism of equity, the ownership structure, is but a consequence of rational actors. They found that shareholders increased the concentration of the ownership structure when stronger control capacity was needed, and decreased the concentration when it was not needed—for example, when the company was exposed to strong state legislation. Thus, ownership structure, i.e., the organisation of equity, is a factor that owners influence in order to fine-tune the governance of the corporation.

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The model is built on a conception of property rights, implying that the distribution of the right to influence the mechanisms are determined by the property rights distribution, as indicated in Figure 1. For example, no matter the interest of a single shareholder in being the central party common to all contracts of the firm, the organisational form of a corporation implies that the right to be the central party has been allocated to the board of directors. No matter the will to gain control, a shareholder who would like to influence the contractual mix of the organisation has to run for board election. Thus, the setup of property rights defines to a certain extent the distribution and content of freedom of action between the principal and the agent, i.e., their capacity to be involved in strategic action.

The area of freedom of action that is left, after the influence of exogenous factors such as the property rights setup and the market structure, can be influenced by the principal. A governance strategy is the conscious choice of the principal to take control of the leeway of every corporate governance mechanism and the mix of the mechanisms. Accordingly, the conception of the CG mechanism is that there are parts of the mechanism, and the mix of mechanisms, that can be influenced through strategic action, and that there is a zero-game situation where the action is either taken by the principal or by the agent. This area of freedom of action is the very basis for a praxis conception of CG. Without any opportunity for strategic action CG would have no praxis implications. Thus, exploitation of the freedom of action is what defines the praxis of CG.

**1.1 The principal**

Exploring the model of governance strategy in more detail, we start with the principal. A principal, however, is not an easy subject to define. One way of distinguishing the principal is

to assume that a principal is created in an institutional milieu where the relevant institutions can be described through property rights. The theory of property rights is a dissent from orthodoxy and was mainly introduced by Coase (1959, 1960), Alchian (1961) and Demsetz (1967). The theory claims that the performance of an organisation is largely determined by the way in which property rights are defined and distributed (Asher, Mahoney and Mahoney, 2005). Basically, property rights are rights to control activities and their effects which are specified by the rules of society, be they norms, regulations, or legislation, implying a privilege, granted and sanctioned by society (Reynolds, 1983). With this conception we do not need the concept of ownership in order to define the principal. Indeed, ownership is mainly a combination of rights and responsibilities with respect to a specific property (Ricketts, 2002), which makes it possible to claim that "...ownership of the firm is an irrelevant concept" (Fama, 1980:290). What is relevant is that the actual distribution of the property rights defines the capacity and the interest of the principal, thus defining the principal.

Alchian and Demsetz (1972) suggested the single proprietor/principal of the classic firm to have bundles of property rights, i.e., the right to be a residual claimant, the right to observe input behaviour, the right to be the central party common to all contracts of the firm, the right to alter the parties of the firm, and the right to sell these rights. However, other forms of organisations have evolved, e.g., corporations and not-for-profit organisations, suggesting a different bundling of property rights. For example, in the corporation the residual rights belong to the shareholders, but in the not-for-profit entity the rights belong to the organisation. These bundles of property rights allocated to different actors have evolved throughout history, and have been institutionalised and ultimately codified in laws of the state.

## **1.2 The agent**

If the principal is defined by the set of property rights, so is the agent. An agent, however, is easier to define. The implementation and fulfilment of the will of the principal, no matter the ambiguous nature of the principal, is the responsibility of the agent. In fact, CG can be defined as those structures and processes that direct and supervise the agent towards the fulfilment of the will of the principal, i.e., towards efficiency.

According to the transaction cost theory explanation, the governance problem of top managers is caused by opportunism, i.e., the probability that managers pursue their own goals instead of the principals' goals, and by bounded rationality, i.e., that the principals have limited information, which is the source of an information asymmetry that could be exploited

by the managers (Williamson, 1975). The bounded rationality assumption, however, has to be expanded to the managers as well. Regardless of their own goals and intentions, managers can have difficulty in interpreting the nature of the principal (due to an ambiguous principal), or in interpreting the goal of the principal (due to ambiguous goals). For example, in a democratic association, the will of the principal can vary due to changing majorities, making for ambiguity of both the character and will of the principal. Adopting the limited rationally assumption seriously, one has to acknowledge that goal deviance could be caused by the managers acting according to stewardship theory (Davis, Schoorman, & Donaldson, 1997), i.e., with the spirit of implementing the will of the principal, but according to transaction cost theory (Williamson, 1975) being imperfect in the cognitive capacity to interpret the goals because of the ambiguity of goals and principal. Ouchi (1980) found the ambiguity to be of such importance that he introduced a third form of governance structure, parallel to market and hierarchy, termed the *clan*. In this structure, the agent faces such a high ambiguity that in order to be capable of being efficient, the agent has to have norms and values in common with the principal, thereby being capable of interpreting the goals of the principal. Thus, corporate governance does not exclusively deal with how to discipline managers, but how to inform managers about the nature of the principal and about the relevant goals.

The agent has to satisfy the will of the principal through the performance of the organisation. This is achieved through corporate entrepreneurship, which is the implementation of the strategy and the creative change of the strategy, i.e., strategic opportunism. There is a tendency in the literature to focus on the implementation part, and to conceive the developmental part as a deviance that has to be restrained. For example, the diversification wave has been interpreted as an outcome of top managers' will to gain power and to earn risk-reduced wealth through size expansion at the cost of owners' profit (Amihud & Lev, 1981). It could, however, be interpreted as an outflow of managers trying to perform the most difficult part of their duties towards the principal, which is to create long-term sustainable efficiency through developing the organisation and its strategy. This is at the heart of corporate entrepreneurship, which can be defined as the capacity to perceive new opportunities and to develop new strategies, be they new products or markets, and to be capable of redirecting its resources (Covin & Slevin, 1991; Zahra, 1996; Zahra & Huse, 2000). The challenge of a governance strategy is to integrate disciplined implementation and creative development into an efficient flow of actions, i.e., to direct corporate entrepreneurship in order to satisfy the needs of the principal on a long-term scale, without losing energy and costs on managerial opportunism.

### **1.3 Corporate governance mechanisms and entrepreneurship**

The influence on corporate entrepreneurship is made through the corporate governance mechanisms. A widely accepted list of mechanisms has evolved which are considered to have a decisive influence on the manager of the organisation (Schleifer & Vishny, 1997). Thus, the mechanisms that the governance strategy is concerned with are: the market for capital, be it equity or debt; the market for managerial labour, be it the external or the internal market; executive compensation; the board of directors; the auditors; the strategy and structure of the organisation; the product market; and finally the organisation's environment, including for example mass media, national culture, regulations by private or public bodies, and state legislation.

The mechanisms are to a certain extent determined by exogenous forces. No matter the interest and hopes of anyone, the interest on debt is hard to influence to a large degree due to the forces of the capital market. This is the exogenous influence on the mechanism, which puts a decisive limit on the governance strategy. But it has to be noted that even the rate of interest can be influenced through, for example, negotiations with a bank or through the corporation being part of a business group (Aoki, 1990; Weinstein, & Yafeh, 1995). Another example of the exogenous influence on the mechanism is the supply of managers on the external managerial labour market. To a certain extent the supply is given by (a) the other corporations in the economy which create managers, and (b) the outflow of students from business schools and universities. But as the corporation can segment its product market, so can it segment its managerial labour market and to a certain extent only attract those that it considers adequate. All in all, no mechanism is entirely exogenous or endogenously determined, thereby creating an opportunity for an actor of governance to use the mechanism to direct the organisation towards the will of the principal, i.e., to create a governance strategy.

By inspecting the different mechanisms, we can find indications of the leeway for the principal and the governance strategy. One can start with the supply of capital, which has the capacity to create opportunities for investments, but since the supply is limited in size, it restricts the size of the investment and therefore restricts the range of possible entrepreneurial actions. Thus, capital rationing is an important means of governing the corporation. Debt capital offers opportunities through its being the basic external means for investments, but it puts a strain on actions due to its continuous demand on cash flow, and when facing risk of bankruptcy, its right to discontinue the firm (Berglöf, 1990). Thus, from a principal's point of

view, presumably with the right to discontinue the firm during normal business, debt offers low cost financing and thereby increased entrepreneurial capacity, but at the price of risking the function as principal. Equity capital supplies the investment with risk capital, but to the cost of the residual and power, i.e., the right to alter parties of the firm and to discontinue the firm despite the risk of bankruptcy. According to the pecking order theory (Myers & Majluf, 1984), internally generated equity, i.e., profit, is preferred over debt, which is preferred over externally generated equity through issuing shares. One interpretation of this order is that it represents the descent of managerial autonomy. Another interpretation, made more on the lines of stewardship theory, is that the order represents the amount of disclosed information needed, i.e., how much the firm has to disclose information, and thereby face the risk of informing its competitors. One has to notice, however, that there are organisational forms lacking shares, such as not-for profit associations that have no opportunity to get external equity, or organisational forms such as co-operatives experiencing huge difficulties in obtaining external equity. The opportunities as well as the restrictions posed by external equity are thereby evaded.

The composition of management is created through recruiting managers from the external market for managerial labour as well as selecting them from the internal managerial supply. The supply of external managers creates opportunities to hire managers outside the organisation with specific skills and with no social investment in the organisation, which increases their capacity to engage in drastic changes of the organisation. The supply of internal managers creates opportunities to use the organisation as a factory producing not only products, but also managers with specific norms and values through the use of socialisation devices, which in turn increases the organisation's opportunities to use subtle controls, such as clan control (Ouchi, 1980). Thus, the use of internal and external managerial labour markets is an important element of a governance strategy in many organisations. It should, however, be noticed that regulations could reduce the freedom to use the internal managerial market. For example, US universities cannot use the internal supply of PhD's for the supply of assistant professors. This again represents an exogenous force putting limits on the governance strategy.

Executive compensation, be it through financial or symbolic rewards, or the dramatic threat of dismissal, is a mechanism that directs action towards ends that can be more or less precise in definition (Gomez-Mejia & Wiseman, 1997). Executive compensation is a complex task. A simple pay-performance relationship does not exist, as indeed surprisingly consistent findings indicate. It has been found that no more than 5% of executive pay is

correlated with the performance of the organisation (Tosi, Werner, Katz & Gomez-Meija, 2000). And it should be stressed that this is the case when the performance of the organisation could be assumed to be rather easy to define and detect. The relationship between pay and performance in organisations where there are unclear goals or a set of goals that cannot be summarised into one single criterion of efficiency will reduce the correlation to almost nil. This does not imply, however, that the principal's freedom of action is endless, but without any governing effect. It implies mainly that it is a mechanism that is hard to use, and that monetary rewards are not the only way of compensating managers. As will be indicated in the cases presented later, advancement opportunities can be part of the compensation scheme, and opportunities to exercise freedom of action can also be regarded as a reward.

The board of directors, supported by a market for directors, aligns the strategy of the organisation with the organisational structure, with the ultimate capacity to give direct orders to the top management, i.e., to directly influence the set of possible actions. The board has been found to have three functions, that of managerial control, strategic decision making, and providing service (Golden & Zajac, 2001; Zahra & Pearce, 1989). This is, though, a set of functions bound to Anglo-American nations. In continental Europe, for example, there is a two-tier system, where one type of board consists of insiders and another type of board consists of an equal mix of representatives of capital and labour. Thus, a fourth function of the board could be to perform as an institutionalised arena for conflict resolution between representatives of the major factors of production. Additionally, the board could be regarded as a device where the principal as well as the needs and will of the principal are identified, negotiated, and recognised. The board is present in many legally recognised organisational forms, i.e., the corporation, the co-operative firm, the voluntary organisation, the association built on members, and in not-for-profit organisations; boards are populated with principals or those recognised as representatives of the principals. The only legal organisational form that does not have a board appears to be the single proprietorship, which is the only form where the principal is clearly and sharply defined. Thus, the board can function as a device for the principal to indicate its presence and its will. As a part of a governance strategy, it can be influenced to a large extent, only restricted by the market supply of directors and by regulations, such as those demanding board representatives from special groups.

“Strategy drives structure” is the widely-known axiom of Chandler (1962), emphasising the importance of congruence between strategy and structure. It has been stated that it might not be the managers that have opportunistic behaviour but the organisational structure fostering that behaviour (Perrow, 1972). Thus, the very structure of the organisation

can stimulate or constrain managers' behaviour. Even here there is an exogenous part since modern strategy theory emphasises the difference between intended strategy and emergent strategy, the latter being less a part of a governance strategy.

On the other hand, we have phenomena, such as diversification, which have been interpreted as being subject to the agent's influence, but could very well be part of a governance strategy. It has been claimed that diversification and the corresponding M-form structure was merely a strategy of and by top managers. The top managers, being risk averse, intended to reduce the risk of the firm through pursuing a diversification strategy, preferably an unrelated strategy, since it was believed to reduce the level of risk (Amihud & Lev, 1981). Later it was found that the risk was not reduced, and on the contrary increased (Lane, Cannella & Lubatkin, 1997). Another interpretation along the lines of a governance strategy could, however, be put forward as equally plausible. First, one has to realise that the risk of the diversified shareholder, that of beta, is not equal to the risk of the top manager. Top managers' reputations are probably built on their capacity to deal with large organisations and to implement organisational change. Their risk conception is probably not the finance conception of risk, i.e., variance, but that of negative outcomes, i.e., losses. Their being risk averse is not a matter of feeling hurt when experiencing high variance, but when black numbers turn into red. Diversification was therefore a strategy accepted by the owners since it made it possible for the top managers to engage in entrepreneurial actions. Investments in one division creating risk of negative outcomes during several years could be absorbed by the diversified corporation, making the total outcome of the organisation a positive one. When the tide changed during the 1980s and the strategy of diversification became unfashionable and severely punished by stock traders, other mechanisms had to be implemented in order to sustain corporate entrepreneurship. Executive compensation appears to have been the preferred alternative mechanism to the diversification strategy and M-form structure mechanisms. Very high level of compensations, combined with "golden parachutes" and option programmes were implemented. The dominating interpretation was again that of top management power, but one could very well interpret executive compensation as part of a rational governance strategy trying to reduce the top managers' experience of risk in order to create opportunities for corporate entrepreneurship.

The organisational structure can to a large extent be influenced through strategic choice, though there are parts that are hard to have an effect on, due to institutional pressure. The old institutional school has claimed that the top managers of large corporations with weak owners are only superficially in control of the corporation. In fact, they could be

regarded as being mentally prisoners of the M-form: "The separation of ownership from control that occurred in many mature corporations gave management a large degree of control, but management quickly lost its control to the conglomerate" (Dugger, 1988, p. 106). Thus, both strategy and structure have elements of strategic choice and elements of determination by exogenous forces.

The role of the auditors is to scrutinise the actions performed by the managers, in the interest of the principals and the state. They are, however, solely focused on the credibility of the information given by the corporation, not on the efficiency of the corporation and the actions performed. Thus, they appear to be an exogenous factor. But not even that is true since matters of governance, such as accounting choice, can be found to be influenced by the specific accounting firm that performs the auditing (Inchausti, 1997), thus making the choice of auditing firm part of a governance strategy.

The output of the organisation is subject to the competition in the product or service markets. With increasing levels of competition, the restraints on management increase, to the point where perfect competition prevails and where not even price can be influenced. A principal could have an interest in placing the organisation in a market where perfect competition prevails, since under these conditions management has no freedom of action, thereby making corporate governance a non-issue. On the other hand, perfect competition does not produce any monopoly rent. So the principal has to make the choice between (a) costless governance without any monopoly rent, or (b) costs of governance and earning of rent through competitive advantage. The rational calculus would be that the principal's share of the monopoly rent gained from competitive advantage should be larger than the costs of governance, including the share of the rent distributed to the management of the organisation.

The governance mechanisms of a single organisation are embedded in the organisation's environment, constituted by, among other things, mass media that offers information and analyses of the organisation to the public, state legislation, and regulations by agencies and associations that influence actions through rules and sanctions. To a large extent, the environment is exogenous since the available opportunity set of governance mechanisms in a nation is a function of the cultural heritage of the specific nation (Lubatkin, Lane, Collin & Very, 2005). But even these parts of the corporate governance mechanisms can be influenced. Lobbying and corporativism (Lash & Urry, 1987) are active ways of influencing the state, while manipulation of the numbers in the public accounts is a passive

way of influencing the mass media through not drawing attention to the corporation (Watts, & Zimmerman, 1986).

#### **1.4 Summarising the concept of governance strategy**

Let us summarise the development of the concept of governance strategy this far. The principal can influence corporate governance mechanisms to an extent determined by exogenous forces, and in doing so influence the agent's capacity to engage in corporate entrepreneurship—thereby improving the probability of the organisation's satisfying the interest of the principal. From the principal's point of view, the agent's task is to identify the principal, to understand the will of the principal, and to satisfy that will through the performance of the organisation. In performing this task, the agent is engaged in corporate entrepreneurship, stimulated and restricted by the governance mechanisms. Leeways in every mechanism have been indicated, though the actual freedom of action for the principal to organise the governance strategy is dependent on the context, due to the exogenous forces. We now turn to the principal and the principal's capacity and interest to engage in consuming resources for the sake of designing a governance strategy.

#### **1.5 The principal's interest and capacity**

The choices of the principal in creating a governance strategy involve two factors: the interest of the principal and the capacity of the principal. A principal's interest consists of the strength and direction of the interest. The strength of the interest is a function of how much effort the principal is willing to spend on putting forward its interest and how much power the principal has in making its interest a legitimate claim. A person holding one share in GM has a strong legitimate claim, but will presumably spend very little effort on putting forward its interest. Accordingly, we cannot expect the formation of a governance strategy from that person. A member of a riding school association has a legitimate claim, and could be expected to have strength if the member invests all spare time in the riding facilities. We will not carry our theory any further back at the present time, but it is clear from the two examples that strength is influenced by the investments made by the principals and the property rights setup that defines legitimacy.

The direction of the principal's interest determines the legitimate efficiency of the organisation. An organisation owned by the state, with the owners' interest being that of producing good health care is inexpressibly inefficient if it produces high profit and low quality health care. An organisation owned by funds with short-term profitability as major

interest, would be utterly inefficient if it made investments with only long-term profitability. Thus, efficiency is a function of the principal's interest. But, as we noted previously, the principal is not always unambiguously evident, which makes it hard to find the legitimate interest. Another case where the legitimate interest is not evident is when the principal consists of several groups or a set of persons that have diverging or even conflicting interests. The implication is that an organisation could be subject to several governance strategies that are designed by persons or groups with legitimate interests as principals of the organisation.

The capacity of a principal to design and implement a governance strategy is the second factor influencing the governance strategy. Information, competence, and governance costs are factors that influence the capacity. Information is needed about the organisation and about the mechanisms and their accessibility for strategic action. Competence is the capacity to reach understanding and conclusions by processing information through the use of theories, gained through education or experience. Thus, to be a capable principal includes both the information and the capacity to make productive use of it, i.e., competence. Finally, governance costs represent the consumption of resources needed in order to gain information and competence, and to assemble the power needed in order to implement the strategy. For example, the presence of shareholders as directors of the board depends on the shareholders' access to information networks, on the shareholders' competence in evaluating company plans, and on what investments in competence the shareholders are willing to acquire in order to gain the necessary competence. Lacking incentives to consume the necessary resources, lacking competence or information access, the rational shareholder will look for an agent that can be a competent director, i.e., the shareholder will use the market for directors in order to find a competent director.

The interest and capacity of the principal is the *causa prima* which puts the model into motion, and the interest of the principal is the final achievement of the movements, as indicated by the efficiency relationship between the performance of the organisation and the principal's interest. This circularity has at its centre the design and implementation of the governance strategy, which creates the foundation for corporate entrepreneurship. The model thereby indicates the prerequisites for a principal's strategic action and the mechanisms that can be part of the governance strategy. Thus, the model does not explain action, but gives conditions for action, i.e., it has a praxis orientation.

The model can be further developed. The factors behind the capacity and interest have only been barely outlined, and the enabling aspect of governance mechanisms through influencing corporate entrepreneurship is especially in need of serious conceptual

development. However, we have confined this initial section of the paper to the conceptual development of governance strategy. In the next section we turn to an illustration of governance strategies through case studies of two particular organisations. Through description and analysis of these organisations, we find indications of validating the model presented in this section.

## **2. GOVERNANCE STRATEGIES IN TWO ORGANISATIONS**

The model of governance strategy can be applied to different organisations, as long as there is a separation between agent and principal. This section is devoted to an analysis of two rather extreme types of organisations. The selected organisations are an Equestrian Association (EA), which is a riding school organised as a democratic association where ownership is lacking, and a Business Group (BG), which is a constellation of large corporations joined in a network through ownership. Since it is accepted that CG research has created general knowledge in this field and applied it to large, capitalistic, listed firms, it is appropriate now to illustrate and validate governance concepts in more exotic organisations, such as EAs and BGs. This may be the toughest test yet of the CG concept, but if it survives the test, then a general conclusion can be made: that the concept of governance strategy is applicable in all organisations. The limitations of space make it hard to describe the selected organisations in detail. They have been described in more detail in other publications, the EA in Collin & Smith (forthcoming) and the BG in Collin (1998). The purpose here, however, is not to test the *model*, which would have put huge demands on the description of the organisations, but is limited to illustrating the relevance and applicability of the *concept* of governance strategy. The relevance of the model is indicated through analysing each of the organisations separately, then providing a comparative analysis that will create further indications of possible relationships.

The EA data were collected during September 2002, using interviews and archival data. Interviews were held with the current chair of the board and one former chair, two former managers of the riding school, and two instructors. Archival data consisted of yearly accounts and all protocols from the board's meetings reaching back to the 1960s, and more or less randomly saved documents from that time period. A unique record covering the hourly utilisation of each horse and pony every day from 1993 to 2001 was also used. The BG

data were collected from the rather rich literature of the group, from annual accounts of the component corporations, newspapers, and interviews of three leading persons in the group.

## **2.1 The Riding School**

The not-for-profit equestrian association (EA) is a riding school, supplying 800 members with riding lessons, horseboxes, and riding facilities such as indoor and outdoor manège. It is governed by the annual meeting of the members, where the main function is to elect the board of directors. The members of the board have always been selected from among the members of the association. The board governs the organisation, which is composed of a manager of the riding school, a part-time administrator, three full-time riding instructors, some part-time instructors, and one groom. It is financed mainly through lesson fees, rents paid for the horseboxes, and subsidies from the municipality that reduce the lesson price for people below the age of 25.

The EA is a public democratic association, implying that the association must accept anyone for membership, and the member must pay in advance a membership fee, thereby gaining a voice and the right to exercise one vote at meetings of the association. This mechanism constitutes a special case of a property rights distribution where the members cannot accumulate voting rights, and do not put any of their wealth at risk. The members, as the principals of the organisation, organise themselves mainly through the annual meeting. In normal years, the election of the board is peaceful and tends to support the suggestions made by the election committee. The members can, however, form coalitions, often based on discontent with the service delivered, and through a kind of “coup behaviour” change the composition of the board. This happened in 1993 when the chair and many of the members were replaced. The new board changed the organisational structure and replaced the manager in 1995. The recruitment was a failure and in 1997 a new young manager was brought in, lacking in equestrian education but bringing experience as an officer of the armed forces. The organisation and the financial problems have since then been stabilised, and the new manager has started to develop the riding school, demanding and being given extensive freedom of action.

As for the scheme of governance strategy, one must notice that a public association internalises the customers (members) as the principals of the organisation. The members tend to be dormant unless dissatisfied. Thus, the influential members, forming the principal of the organisation, are those with ideas how to run and improve the association and

have the spirit, drive, and capacity to form a coalition. They tend to be highly informed about the organisation since they use the organisation's services. But in this case they tend to be less competent to manage a riding school since they are lay persons with riding only as a hobby. Finally, they have high governance costs since they have to form a coalition and consume non-paid leisure time, which they most likely would prefer to spend on horse riding instead of team building. The interest of the principal is in the service delivered by the organisation since they also are customers of the organisation. The strength of the interest can be regarded as rather small since there could be opposing groups within the general membership.

The governance strategy is weak overall. The reason is that the character of the principal is uncertain, depending on the existence of members who can assume the high governance costs. Many mechanisms are weak, such as equity and debt, since they tend to be very small or even absent. The managerial labour market is weak since the small organisation cannot offer a career ladder. The focus is on the board and its capacity to make decisions about the organisation—especially the selection of a manager. The riding school board recruited a dynamic manager, but lacking a compensation system where monetary reward was dominant, they had to rely on non-monetary rewards, in this case freedom of action. Thus, they acquired a manager with an entrepreneurial spirit by means of the selection and compensation systems.

The EA manager, given a high degree of freedom, was creative and improved areas of the riding school and its services. The school's performance was regarded by the dominant group as having been improved since the horses were well utilised, the costs of the lessons did not increase too much, and the number of pupils in each lesson could be reduced, which meant more teacher attention to each pupil. The board had reduced its role to the monitoring function and, on certain occasions, to providing service.

The governance strategy of a not-for profit organisation engaged in the Swedish riding industry apparently uses few governing mechanisms. The board is the most important of these, but the board's freedom of action is limited by the need to compensate the agent through delegating high levels of managerial discretion.

## **2.2 The Business Group**

Most of Sweden's largest listed corporations are governed by business groups, and among them, the largest and most influential is the Wallenberg group. A business group is a set of legally independent, usually listed corporations joined together by one or more links, such as equity, debt, managers, and/or directors. The Wallenberg group takes its name from the

Wallenberg family of financiers, which controls the group. Control is established mainly through control of a large foundation, established in the early 1900s. The fund controls an investment corporation (Investor), which in turn controls manufacturing firms such as Atlas Copco, Gambro, Astra-Zeneca, and partly ABB and Ericsson, mainly through ownership of shares. Thus, the influence base consists of the property rights contained in the holding of the corporate stock.

The principal can be identified through scrutiny of the board of directors of the group's many corporations, and especially the board of Investor AB, the investment corporation. Chairs of the manufacturing corporations populate the Investor board, but it is more important to notice that there are three representatives from the Wallenberg family on the board. The capacity of the principal is very high since the Wallenberg group has an investment corporation where there are special Business Teams (Investor, 2003) that continuously evaluate the corporations in the business group, using both public information, and presumably information from chairs of the different boards. Thus, they have superior information. They have a strong competence in business, not only because they have lived their whole professional life in the Wallenberg group and its environment, but also because they have access to the Wallenberg network that has been established through more than 100 years of international business activities. The governance costs are, of course, not low, but presumably relative low because of the access to the chairs of the included corporations. The interest of the principal is not easy to identify. The strength is, of course, considerable, considering the control of the corporations. The direction of the interest can, however, be subject to debate. The Wallenbergs being a finance family, one would expect profit maximization. And this is probably the case, but the time horizon makes it harder to discern. The investment corporation has a rebate on its price, i.e., the market value of the corporation is less than the market value of the shares owned by the investment corporation. Thus, it appears that the interpretation of the stock market is that the Wallenbergs do not create value, but destroy it. It has been suggested that the rebate arises because the Wallenbergs do not treat the investment corporation in isolation, maximizing the value of the corporation, but treat it as a centre of the business group, and use it to maximize the value of the group. Be that as it may, profit is presumably a very distinct and important goal in the group, but survival of the family group is probably the overriding goal.

The governance strategy is very strong, mainly because the group appears to utilise almost every mechanism. Equity may be the weakest mechanism since the Wallenberg family is not a rich one, and the locus of control, the investment corporation, cannot issue new

stock because of the rebate. They control through smart equity investments, keeping them to a minimum, using shares with different voting rights, and through controlling the appointment process. Their competence and their reputation cannot, however, be ignored as a power base.

The strongest mechanism is probably the use of the external and especially the internal managerial labour market. They have always used their different corporations as a nursery for managerial talents headed towards the top positions in the group. Today they even have a corporation that appears to be fully employed in organising the managerial labour market (Novare Human Capital).

Debt is handled by their corporations, but one of Sweden's largest banks (Skandinaviska Enskilda Banken) belongs to the group, making it possible for the group to use it for financial service and competence, resembling the German tradition of a *Hausbank*. Executive compensation follows current practices of using both performance-related compensation (i.e., compensation that can be related to the performance of the manager) and stock market compensation, such as options and shares.

The board is the other main mechanism of control in the group. The group have always has several directorships on the different corporate boards. Often they even hold the chairmanship. Individual directors are identified in Sweden as belonging to the business élite. They are typically retired CEOs from some of the corporations in the business group. And they are co-ordinated through such convivial mechanisms as being invited to dinners at the family residence at Täcka Udden in Stockholm.

The strategies of the manufacturing corporations are typically related, international strategies. Diversification is not something that is promoted in the group, partly because the group as a whole is diversified, and partly because the Wallenberg family tends to assume rather high levels of risk.

The final governance mechanism, the output of the organisation, tends to be highly competitive since most of the corporations tend to operate on global markets, where competition is considerable, though many of the markets are governed by patents.

The entrepreneurial activities can be considered as diverse. The corporations tend to have high risk, one reason being their high proportion of research and development. Major strategic changes are, however, not frequent in the group. One example is the now disinvested corporation Stora, the presumably oldest corporation in the world, which made two major strategic reorientations, from copper to iron and then to wood products, during its more than 700 years of existence (Bengtsson, 1988). Another example is Ericsson, a telecom corporation that was one of the earliest inventors of mobile phone technology. Ericsson could

not, however, capitalise on this early entry since it could not convert its business-to-business orientation to a consumer orientation. Though famous for its superior technology, Ericsson could not understand, for instance, why a mobile phone should be available in red. A further example is car producer Saab, which has been trying to convert from the single business of building aircraft to the diversified business of building cars and which has been sold to GM. It appears that consumer products are not well understood in the group.

The performance of the group from the family’s point of view should be considered very high since the group has existed from the end of 1800 until today, and has created the most internationally oriented corporations in Sweden. Among the family businesses of Sweden, they are among the few that survived the turbulent ownership restructuring wave of the 1970s.

**2.3 Comparative analysis of the two organisations**

The two organisations differ in many respects, making them adequate as contrasting examples of governance strategies. A comparison between the two organisations can therefore be expected to yield some insights into the concept of governance strategy. The comparison that will be used here involves a quantitative codification of the organisational data, rather than a qualitative representation of case data. Every mechanism has been coded according to a three-point scale. All variables, i.e., the exogenous influence and the governance emphasis by the principal for each mechanism, the capacity and interest of the principal, and the corporate entrepreneurship, have been interpreted as 1 for low, 2 for moderate, and 3 for strong. Of course, the assessment is highly subjective, with huge risks of creating errors in codification, but it has the advantage of being able to summarise data observations and to present it in a simple manner.

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Insert table 1 about here  
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Table 1 reports the comparative assessment of the two organisations. Information capacity is very high in the BG because the family has a strong network and long experience of the businesses, while the EA has principals with limited experience of running organisations, but good information about riding. Governance costs are very high for EA since they have to form alliances, i.e., assume the costs of collective action, while the BG has lower costs due to

being more or less an integrated family and with directors in the network that have been part of the BG for many years. The strength of the principals' interest differs since the association's members are engaged through their leisure interest, while the business group's engagement emanates through 100 years of family involvement. Summarising, the principals of the two organisations differ widely, the EA having a principal with less strong interest and weak capacity, while the BG has both a strong interest and strong capacity.

From inspection of the governance mechanisms, it appears that the EA experiences a rather low pressure from exogenous factors. The managerial labour market is very weak due to low supply of potential managers. There are no strong norms of compensation, board behaviour or board composition, except for a tradition of only selecting directors within the membership cadre. The auditors are elected in trust from among the members. The only strong pressures that can be identified are (a) the norm of a riding school being expected to produce certain kinds of services, such as dressage and jumping, and (b) the norm of adopting a low-cost strategy, with a special focus on providing service to young people. Thus, the strategy of riding schools appears to be taken for granted, i.e., institutionalised. The EA does not pay much attention to the mechanisms of capital, auditors, strategy, or the product market. On the other hand, it appears to exclusively use the external market for managers since the last recruitment was external, in spite of there being internal candidates. The board of directors is the major arena of influence, and the organisational structure appears to be always considered through suggestions at the board level and through organisational restructuring. As explained earlier, executive compensation through delegating wide freedom of action to the manager, was a major instrument of promoting corporate entrepreneurship. As indicated by the summary of ratings at the foot of Table 1, the EA is characterised by rather weak influence on their corporate governance mechanisms. The governance strategy is of great variety, as indicated by the standard deviation, and is mainly focused on the board of directors and on the utilization of the external managerial labour market.

The BG appears to exist in a different kind of environment where the exogenous forces are rather influential. In Table 1, the only low score is for the internal labour market, which is codified low because of a rather weak tradition of internal recruitment in the different industries. Examination of the governance emphasis column indicates a rather low variance in a strong governance strategy. Debt, internal recruitment, compensation, strategy, and structure are all mechanisms that are influenced and used to a large extent by the BG. Equity is of less importance since the family does not have strong financial capacity. The

external labour market is seldom used at the top levels due to the reliance on the socialising strategy of control. The board is of great importance, but the election of directors must to a certain extent consider industry politics and societal legitimacy, thus reducing its importance as a governance mechanism. Summarising the results, it appears that the governance strategy of the BG is rather strong and rather consistent across mechanisms.

Comparing the two organisations, there appears to be a correlation between capacity and strength of interest and the governance strategy. This accords with our expectations of the model expressed in section 1 of this paper. On the other hand, there appears to be a correlation between exogenous influence and governance emphasis since each organisation shows about the same number of total points in each column. That result is at first sight counterintuitive since stronger institutional forces would imply less leeway for the principal, thus reducing the capacity and the opportunity to influence the mechanisms. But another interpretation could be that increasing exogenous influence puts larger demands on the governance strategy, forcing the principal to a higher level of governance engagement. Simply put, tougher environment creates tougher beasts.

Another observation from Table 1 is that the two organisations do not share any one mechanism as the most emphasised. The EA stresses external supply of managers, BG stresses internal supply. This could be explained through the BG's large networks that create the necessary flows of ideas and its having a socialising control strategy, thus emphasising internal recruitment; the EA by comparison has small networks and therefore is in a need of impulses which it will get through an externally recruited manager. The BG stresses executive compensation, which it can afford; EA stresses the board, which could be a way of more directly influencing the manager. One interpretation of this behaviour could be that the emphasis on the board is a means of compensating for the lack of capacity to use many of the other mechanisms. In other words, if you cannot use the whole orchestra, as the BG can, in order to produce a strong sound, you will have to make a louder sound with the only instruments you have available, like the EA, in order to create the same effect.

Summarising these observations with the intent of fertilising the model of governance strategy: the capacity and interest of the principal appear to influence the governance strategy; the exogenous influence does not appear to put a limit on the principals' capacity to utilise it, but only puts a demand on the force with which the principal uses the mechanisms, and finally, in the mix of mechanisms, a limited capacity to mix many mechanisms will induce even stronger emphasis on the available mechanisms.

### **3. CONCLUDING REMARKS ABOUT GOVERNANCE STRATEGY**

Corporate governance is not a subject limited to explanation, but can be used in a praxis-oriented approach, as a device for promoting action. This device has here been termed governance strategy. The proposed model indicates how performance will be created through the entrepreneurial actions that are promoted and restrained through the governance mechanisms, of which some or part have been influenced by the principal through the governance strategy.

The two empirical cases showed how the mechanisms have been used in two different settings. The analysis indicated that the strength of the principal and the exogenous influence both affected the strength of the governance strategy. Additionally, when the mix of the mechanisms is unbalanced, it could indicate a weak principal, focusing its limited power on one or a few mechanisms. These observations are however restricted to only two case studies, which makes it presumptuous to convert them into propositions.

The model contributes to the understanding that corporate governance is an issue for every organisation where property rights of control and execution have been divided between at least two parties. The case studies highlight that governance is not limited to listed corporations, but also includes those organisations where ownership cannot be clearly identified. What matters is not ownership, but distribution of property rights. Thus, it can be argued that a theory of corporate governance has to be founded on the conception of property rights, including both legally and socially defined. Without a conception of property rights, it can be hard to identify a principal, which is the starting position for every corporate governance analysis. Such an analysis is not limited to researchers, but the praxis orientation implies that even a manager acting as agent needs to perform such an analysis since the principal and the will of the principal needs to be known before the managers can start to produce organisational performance.

The major principle behind the model is that it can be used for stimulating or evaluating action. If used in reverse, it can be used to identify actions of governance strategy, and thereby identify the principal and the principal's capacity and interest. This is especially needed in organisations where the principal is hard to identify, as could be the case in organisations relying on collective action, such as the riding school case.

The model can be used in a forward-looking manner in two different ways. One way is to use it to evaluate a specific governance strategy. Small shareholders could use it in order to evaluate the dominant shareholders' methods of governing the corporation. A single

member of the riding school could use it to find out if the dominant group of members utilises the mechanisms in order to satisfy their interests.

The other way of forward usage is that it can be utilised to indicate possible governance actions for a dominant principal. Through finding out its capacity and interest, and the environment and the agent's capacity to influence the mechanisms, the scope of actions available to the principal and the appropriate strength of actions in the different mechanisms can be found. It can therefore be of use where all theories should end up, in praxis.

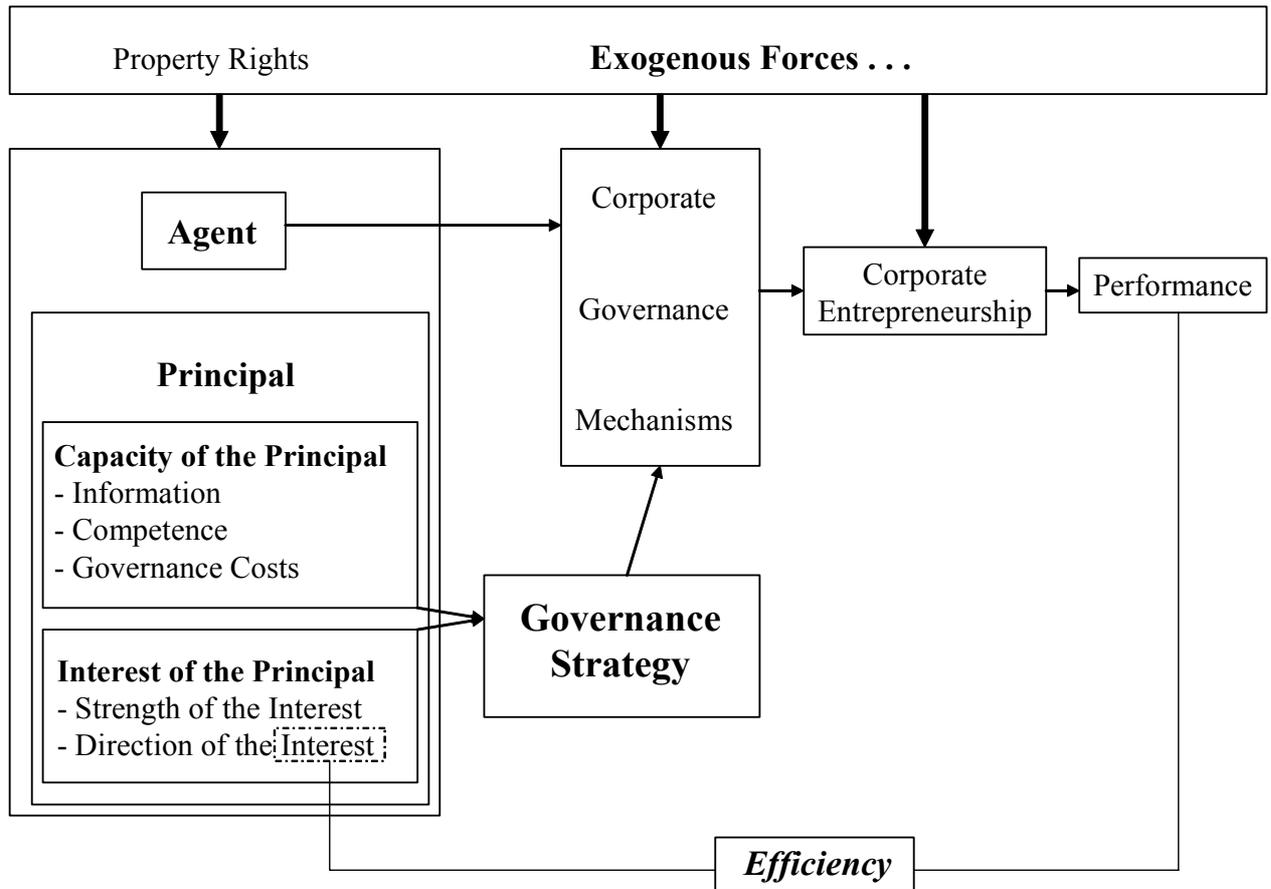
Models such as the one proposed here, however, have to be refined and further evaluated through empirical validations and tests. Conceptually, the model can be further developed through finding the factors that influence the capacity and the interest of the principal, as indicated earlier. The corporate entrepreneurship "box" in Figure 1 is mainly a black box, thus having the same limitation as most corporate governance research, being occupied with restrictions and less engaged in the enabling aspect of corporate governance. This bias implies a cry for conceptual development with the aim of integrating corporate governance and corporate entrepreneurship. Finally, a principal has to create a mix of the governance mechanisms through the governance strategy. It is a real challenge for research to do the same, i.e., to find out if there are any relationships between the different mechanisms.

On the empirical side, the model could be tested using survey data, although such a survey would present huge operational problems. More importantly, this could be the final test of its praxis orientation, i.e., whether the model stands the reality test and can be used for action. This could be done in a scientifically controlled way through action research, for example, where the manager, the chair of the board and a representative of the principals are given the assignment of doing the same assessment as was performed in this paper on the two organisations. It will help the principal and the manager of the organisation to better realise the circumstances and situation of the organisation, and it will provide the researcher with high quality data.

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**Figure 1. Governance Strategy**



**Table 1. Comparison of Two Organisations**

	<b>Equestrian association</b>		<b>Business group</b>	
	<b>Exogenous influence</b>	<b>Strategic action</b>	<b>Exogenous influence</b>	<b>Strategic action</b>
<b>Capacity of the principal</b>				
Information		2		3
Competence		1		3
Governance costs*		1		2
<b>Sum</b>		4		8
<b>Interest of the principal</b>				
Strength of the interest		2		3
Direction of interest		Service		Profit
<b>Governance Mechanisms</b>				
Market for capital				
Equity	0	0	3	2
Debt	1	1	3	3
Market for managerial labour				
External	1	3	3	2
Internal	1	1	1	3
Executive compensation	1	2	3	3
Board of directors	1	3	2	2
Auditors	1	1	3	2
Strategy	3	1	2	3
Structure	1	2	2	3
Product market	2	1	3	2
Environment				
<b>Sum</b>	12	15	25	25
<b>Stddev</b>	0.789	0.972	0.707	0.527
<b>Corporate Entrepreneurship</b>		4		5

\* Governance costs are inverted