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Evidence from Iceland

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HÁSKÓLI ÍSLANDS

The Role of the Board in SMEs

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Discussions about the role of boards in companies are often puzzling because the underlying theoretical frameworks differ. Many theories can be found in the literature underpinning various perspectives and which may possibly lead to challenging arguments (Hung, 1998; Johnson, Dayly, & Ellstrand 1996; Zahra & Pearce, 1989). Some researchers argue a general theory of the board is needed which avoids such confusion (Stiles & Taylor, 2001), as well as an appropriate conceptual framework to adequately reflect the reality of governance (Tricker, 2000). Different perspectives and a vivid theoretical debate are not unusual in a relatively young field of study such as corporate governance (Ulhøi, 2007). Tricker (2000) points out research in corporate governance is merely a few decades old, and the phrase 'corporate governance' was seldom used until the 1980s. This is interesting, as boards of directors can be traced back to the nineteenth century (Chandler, 1977) and because *The Modern Corporation and Private Property* by Berle and Means, published in 1932, is often quoted as the introduction to the field.

The main thesis of Berle and Means (1932) was ownership had become so dispersed there was no real owner of organisations, which in turn empowered managerial control of organisations. Many researchers question whether this is as common a problem as indicated, because ownership is much more concentrated in most companies (La Porta et al., 1999; Faccio & Lang, 2002, Lubatkin, 2007). La Porta et al. (1999) and Faccio and Lang (2002) have studied ownership structure in several countries, and found corporate ownership is concentrated in most countries, although to a lesser degree in Anglo-Saxon countries, supporting the categorisation of Weimer and Pape (1999). Many researchers have questioned the claim of dispersed ownership, and how commonly corporations are management-controlled (Demsetz, 1983; Demsetz & Lehn, 1985; Shleifer & Vishny, 1997). Lubatkin (2007) argues the problem of dispersed ownership is non-existent in the majority of companies on a global scale. Ownership is usually very concentrated in small en medium sized companies (Heuvel et al., 2006), which makes it clear who has the control of the company. The role of the board could therefore be theoretically different in small and medium sized companies than large organisations.

This paper is based on a survey, which was sent out to 560 SMEs in Iceland, and 21% of the companies responded to the survey. Iceland was chosen primarily to solve the problem of access (Fidler, 1981; Hill, 1995; Stiles & Taylor, 2001). The Icelandic Stock Exchange was the main sponsor of the survey, which lent more credibility. This is a descriptive study based on the perceptions of CEOs, which sit most board meetings but do not have voting rights on the board. The objective is to find empirical evidence for what boards in small and medium sized companies actually do in terms of tasks and roles.

Literature Review

Archetypes of roles

There is ambiguity in the literature as to what roles boards perform, and the definition of those roles (Heuvel et al., 2006). Many labels for roles often seem the same, and researchers interpret these roles differently.

The first study of roles and tasks has been traced back to Mace (1948) (Heuvel et al., 2006). However, there are not a lot of studies on the role of boards. Gabrielson and Huse (2005) found 127 empirical articles on boards and governance in six leading academic journals from 1990 to 2002, only 27 with primary data. Heuvel et al. (2006) note around 30 articles have discussed board roles and tasks from 1980 to 2004. It is not surprising there has been a constant call for research focused on board roles and tasks (Leblanc & Gillies, 2005; Stiles & Taylor, 2001; Zahra & Pearce, 1989).

The most common approach is to define board roles as tasks (Heuvel et al., 2006; Huse, 2005; Nicholson & Kiel, 2004; Kula, 2005; Zahra & Pearce, 1989). The starting point for discussion is often the literature review by Zahra & Pearce (1989). The three roles, Control, Strategy and Service, are often considered representative of key activities board need to address (Huse, 2005; Nicholson & Kiel, 2004). However, there is some confusion in the literature about what these roles constitute in terms of tasks.

There is least confusion about the Control role (Heuvel et al., 2006). The labels Control and Monitoring are often used synonymously, although they may be defined differently. According to agency theorists, effective boards independently monitor strategic challenges facing the firm, and evaluate management performance addressing them (Beatty & Zajac, 1994; Fama & Jensen, 1983). Directors may overturn poor decisions and replace ‘underperforming’ managers as a result of such monitoring (Brudney, 1982). The board, therefore, controls management by monitoring its decisions and actions. The definition of the control role is much the same in the integrated model, where directors monitor managers as fiduciaries of stockholders (Zahra & Pearce, 1989).

The Strategy role leads to the most confusion, as it sometimes forms part of the Control role (which can be related to the Zahra & Pearce (1989) discussion of agency theory), and sometimes part of the Service role, when not defined as a separate role on its own. For example, in the review of Johnson et al. (1996), which is an update on Zahra and Pearce’s (1989) work, the strategy role is omitted, and the Service role, Control role, and Resource dependence role as used instead. Johnson et al. (1996) define the Service role as directors advising the CEO and top managers on administrative and other managerial issues, as well as more actively initiating and formulating strategy. The Strategy role described by Zahra and Pearce (1989) is therefore partially included in the revised definition of the service role. The Resource dependence role, facilitating the acquisition of resources critical to the firm’s success, is found in the description of resource dependence theory (Johnson et al., 1996). Nicholson and Kiel (2004; p. 454), referring to Zahra and Pearce (1989) and Johnson et al. (1996), describe the three roles as follows: (1) controlling the organisation (including monitoring management, minimising agency costs, and establishing the strategic direction of the firm), (2) providing advice to management (which may include providing advice on strategy and is sometimes classified as a component of the control role), and (3) providing the firm, through personal and business contacts, access to resources (including access to finance, information, and power).

Some researchers emphasise the importance of the Strategic role (Demb & Neubauer, 1992; Stiles & Taylor, 2001; Zahra, 1990). Directors, in some cases, may provide ongoing advice to top managers on possible strategic changes, or the implementation of existing strategies (Demb & Neubauer, 1992, Lorsch & MacIver, 1989). Nicholson and Kiel (2004b) add a separate Strategy role for three reasons: (a) increasing performance pressures applied by institutional investors (Black, 1992), (b) board perception of the importance of the strategising role (Tricker, 1984), and (c) recent legal precedent placing corporate goal-setting and strategic direction within the board's charter (Kesner & Johnson, 1990). Nicholson and Kiel (2004b) use four roles in their study, monitoring and controlling, strategising, providing advice and counsel, and providing access to resources. However, many authors have noted the persistent challenge of allowing directors to make a meaningful contribution to company strategy, even though they have the power to do so (Demb & Neubauer, 1992; Lorsch & MacIver, 1989; Westphal, 1999; Westphal & Zajac, 1995). Others have noted the Strategic role is only relevant in cases of crisis (Mace, 1971; Stiles & Taylor, 2001).

Some researchers have used just two dimensions. Tricker (1994) uses the roles of Conformance and Performance. Berghe and Baelden (2004) define the Monitoring role and Directing role as the leading tasks of the board, categorising other roles under those two categories. In other words, the eight roles Hung (1998) describes are reduced to two (table 1). The dual board roles seem to be gaining popularity in research, although there is still ambiguity about the definition of the Directing role, that is Service, Pilot, Resource dependency, Advice and Counsel, or Strategy role.

Although different role labels have been introduced in the literature, the above categorisation emphasises there is no fundamental philosophical difference between those roles, which are more like competing metaphors. The ambiguity on the Direction side can be clarified better in terms of tasks of the board.

Table 1. The roles of boards as two functions (adapted and expanded from Berghe & Baelden, 2004)

Studies	**Direction**	**Monitoring**
Heuvel et al. (2006)	Service role	Control role
Lorsch and Carter (2004)	Pilot role	Watchdog role
Garratt (2003)	Policy formulation & Strategic thinking	Accountability & Supervising management
Forbes & Milliken (1999)	Service role	Control role
Westphal (1999)	Advice and counsel	Oversight and control
Christensen & Westenholz (1999)	Resource acquisition role Strategy role	Control role
Hung (1998)	Linking role Strategic role Support role	Control role Coordination role Maintenance role
Tricker (1994)	Performance role	Conformance role
Demb & Neubauer (1992)	Pilot role Trustee role	Watchdog role
Zahra & Pearce (1989)	Service role Strategic role	Control role

Methodology

Operationalisation of tasks

The concept of board of directors can be conceptualised and measured from different perspectives. The roles of the board are the main focus of this study, as they have been used widely to conceptualise boards within the process view of the board (for example Zahra and Pearce, 1989, Johnson et al., 1996, Heuvel et al., 2006).

Composition of the board has been used most frequently for convenience, with references to the structural-based view of the board.

The operationalisation of Heuvel et al. (2006) was the most recent study found at the time this study was operationalised. Their eleven tasks are based on a series of studies (Finkelstein & Hambrick, 1996; Hillman et al., 2000; Hillman & Dalziel, 2003; Johnson et al., 1996). Heuvel et al. (2006) was chosen as a starting point for the operationalisation of roles. The two factors in their study were the 'control' role, and 'service' role. Furthermore, operationalisation of the 'monitoring role' and 'advice role' from Carpenter and Westphal (2001) were considered to broaden the measurement, although there was some duplication between the scales. The measurements of Judge and Zeithaml (1992) were also considered, although they did not influence the final design of the instrument. The instrument for measuring the monitoring, resource, and advice roles of the board here, was therefore based on two studies (Carpenter & Westphal, 2001; Heuvel et al., 2006), both of which developed their instruments from several qualitative and empirical studies. By combining them it was possible to include tasks in this study that represent three conceptually different roles of the board. The instrument used in this study consisted of 10 items to measure the monitoring role, resource role, and the advice role.

Several researchers have discussed the strategic role of the board (Andrews, 1980; Baysinger & Hoskisson, 1989; Daily et al., 2003; McNulty & Pettigrew, 1999; Judge & Zeithaml, 1992; Shen, 2003; Zahra & Pearce, 1989). Most used a single item measure. This study intended to measure the complex concept of strategy, so a search for an appropriate measurement instrument was conducted in other disciplines. The search within top management team literature and leadership literature resulted in several possibilities

The Kanji (2002) Leadership Excellence instrument was chosen, as it reflects strategic formulation from the perspective of the strategic planning school. The instrument adapted from Kanji (2002) has 18 items and six factors. As the instrument was developed for leadership research, four items were dismissed, as they were questions about leadership excellence. Otherwise, there was only need of minor changes in the instrument, substituting the word 'leader' for the word 'board,' and changing the scale from 10 points to 7 points. The instrument covered items used by other researchers in the field of corporate governance. The adapted instrument was categorised into four factors: organisational values, vision, mission, and strategy.

The instrument for measuring the strategic role of the board used in this study was based on the understanding a broad measure would give a richer picture of the relationship between boards of directors and organisational performance. The purpose of using a broad measure for the strategy role was to demonstrate greater construct validity in regard to the strategic role, as well as to learn more about this role of the board from an exploratory perspective.

Empirical Findings

A factor analysis on all board role items with Eigenvalue of 1 gave a five-factor solution, with a clear strategy role factor, service and resource factor, value factor, and two monitoring factors. The five factors explained 72% of the variance. A better three-factor solution resulted in a clear strategic role factor (with value, vision, mission and strategy included), a service and resource factor, and a three-item monitoring factor.

Table 2. Factor analysis for roles as tasks

	Factors		
Items	Strategy	R&A	Monitor
5.4 vision future	.832		
5.6 vision confidence	.825		
5.9 mission current	.816		
5.8 mission commitment	.805		
5.7 mission purpose	.799		
5.5 vision communication	.796		
5.10 strategy policies	.774		
5.11 strategy change	.728		
5.3 values systems	.696		
5.12 strategy guide	.679		
5.14 strategy perf monitor	.636		
5.1 values meanings	.600		
5.2 values decision	.587		
5.13 strategy resource empl	.486		
5.15 monitor responsibility	.483		
5.22 advice on strategy		.771	
5.24 resources networking		.771	
5.20 advice ceo assistance		.745	
5.21 advice sounding board		.659	
5.23 resources reputation		.618	
5.25 resources access re		.593	
5.19 monitor compensation			.694
5.17 monitor evaluates			.567
5.16 monitor decisions			.564
5.18 monitor ceo judgement			.460

Extraction Method: Principal Component Analysis.
Rotation Method: Varimax with Kaiser Normalization.
a Rotation converged in 5 iterations.

These three factors explained 63% of the variance. One item, 5.15 - The board determines management's responsibility - loaded equally on the strategy factor and the monitoring factor, with under .5 factor loading in both cases (table 2).

Therefore a clear distinction between the scales chosen for exploring the role of the board was established. The three factors were theoretically distinct as the strategy factor related to stewardship theory, monitoring factor to agency theory and the resource and advice factor to resource dependency theory. Each of the three-factors will be discussed in more detail.

The strategic role consisted of 14 items, measured on a seven-point scale from very little to very much. Kanji's and Sá (2001) and Kanji's (2002) construct for leadership excellence has four components which theoretically can be separated. Table 3 shows Cronbach alphas reported by Kanji and Sá (2001) and those for this study.

Table 3. Strategic role compared to the original scale

Construct	**Reported Alphas** Kanji and Sá (2001)	Cronbach **Alpha** This Study
Values	.844	.923
Vision	.736	.930
Mission	.790	.912
Strategy	.906	.921

Measurement of the reliability of the scale showed Cronbach alpha .958 for the fourteen items, with 106 cases included in the analysis (listwise deletion for missing values). All items were relevant and important (table 4).

Table 4. Strategic role scale.

Strategic Role - Items		**Factor loading**
5.1	The board develops shared meaning and interpretation of reality.	.756
5.2	The board uses organisational values to guide decision making.	.746
5.3	The board puts in place reinforcement systems consistent with organisational values and principles.	.805
5.4	The board creates a compelling vision of the future of the organisation.	.885
5.5	The board communicates the vision effectively.	.832
5.6	The board inspires confidence in the vision.	.872
5.7	The board identifies the organisation's purpose.	.881
5.8	The board generates commitment among all members for the chosen purpose.	.833
5.9	The board keeps the mission current.	.833
5.10	The board develops policies and strategies consistent with the organisation's mission, vision, and values.	.843
5.11	The board anticipates change.	.755
5.12	The board guides change.	.768
5.13	The board monitors resources and uses feedback to review strategies.	.692
5.14	The board monitors organisational performance and uses feedback to review strategies.	.762

Alpha	**Mean**	**SD**	**Skewness (CR)**	**Kurtosis (CR)**
.958	4.440	.119	-.300 *(.235)*	-.665 *(.465)*

The monitoring role consisted of five items, measured on a seven-point scale from very little to very much. Measuring the reliability of the scale showed a Cronbach alpha of .724 for the five items, with 112 cases included in the analysis. Item 5.18 - The board defers to the CEO's judgment on final strategic decisions - did, however, decrease the reliability. The Cronbach alpha would have been .782 had it not been included. The factor analysis gave a two-factor solution with item 5.18 as a stand-alone factor, explaining 20% of the variance. A one-factor solution had only a .217 loading. Item 5.18 was therefore deleted from the scale, and only four items remained in the new scale. Item 5.18 was one of the original items in the three-item scale of Carpenter and Westphal (2001). For the four item scale the Eigenvalue for the first component was 2.479, explaining 62% of the variance. All items had factor loadings higher than .72 (table 5).

Table 5. Monitoring role scale

Monitoring Role - Items				**Factor loading**
5.15	The board determines management's responsibility.			.764
5.16	The board monitors top management strategic decision-making.			.892
5.17	The board formally evaluates the CEO's performance.			.756
5.19	The board determines salary/compensation of CEO and top management team.			.727
Alpha	**Mean**	**SD**	**Skewness (CR)**	**Kurtosis (CR)**
.782	4.699	.125	-.291 (.228)	-.558 (.453)

The third factor in board role analysis from the preliminary factor analysis was what had originally counted as two scales, the advice scale, and the resource scale. This resource and advice scale was made up of six items and was measured on a seven-point scale from very little to very much. The reliability of the scale showed a Cronbach alpha of .865 for the six items, with 110 cases included in the analysis (table 6).

Table 6. The resource and advice role

Resource-Advice Role - Items				**Factor loading**
5.20	The CEO solicits board assistance in the formulation of corporate strategy.			.797
5.21	Directors are a "sounding board" on strategic issues.			.747
5.22	The board provides advice and counsel to the CEO on strategic issues.			.762
5.23	The board builds organisational reputation.			.799
5.24	The board focuses on networking and company.			.835
5.25	The board provides access to extra resources.			.720
Alpha	**Mean**	**SD**	**Skewness *(CR)***	**Kurtosis *(CR)***
.782	4.655	.118	-.484 *(.230)*	.058 *(.457)*

Conclusions and discussions

What boards actually do is an important issue addressed in corporate governance literature (Tricker, 1994). In the literature review, four roles were conceptualised and operationalised for the purpose of this study: Monitoring role, Strategic role, Resource acquisition role, and Advice role. Some researchers (for example Westphal, 1999; Heuvel et al., 2006) have used the label Service role for all roles for direction (e.g. Strategic role, Resource acquisition role, and Advice role). This study, therefore, expands research into the direction function of the board, especially in regard to the Strategy role, as a much broader measure of strategy was adopted for this study. The factor analysis resulted in three clear factors: Monitoring role, Strategic role, and Resource and Advice role. The last two roles loaded on one factor. The study concluded the boards in this sample had three main roles.

The three roles isolated by factor analysis represent empirical support for those suggested by other researchers, who often used different labels (Christensen & Westenholz, 1999; Demb & Neubauer, 1992; Lorsch & Carter, 2004; Zahra & Pearce, 1989). Furthermore, the results support findings of other researchers within the context of small and medium-sized firms and family firms (Deakins et al., 2000; Gabrielsson & Winlund, 2000; Johannisson & Huse, 2000; Mustakallio et al., 2002).

All three roles are important, as the means of the roles were high in all cases (table 7). The monitoring role seemed to be the most important role, as it had the highest mean, although the difference between the monitoring role and the resource and advice role was not significant. The difference between the strategic role and the other roles, although very small, was statistically significant, indicating there was more focus on the other two roles. This was interesting, as Heuvel et al. (2006) found the service role more important than the control role in Belgian SMEs. The result of this study does not mean respondents think the strategic role is less important, just that they seem to focus less on it.

Table 7. The mean and standard deviation of the role factors

Roles	Alpha	Items	Mean	SD
Strategic role	.958	14	4.440	.119
Monitoring role	.782	4	4.699	.125
Resource- & Advice role	.782	6	4.655	.118

The strategic role has usually been measured either with a one-item measure or only a few measures (Heuvel et al., 2006; Westphal & Carpenter, 2001), if measured at all. Furthermore, it is difficult to identify the theoretical background within the strategic literature for the items. In this study the Strategic role was emphasised using instruments for operationalisation adapted from the leadership literature (Kanji, 2002; Kanji & Sá, 2001). The scale proved to be robust, with an alpha of .958 and all fourteen items loading on the factor, with .692 loadings or higher. Furthermore, the mean of 4.440 can be seen as an indication boards are heavily involved in the strategic role. This study supports research findings on the importance of the strategic role for boards (Demb & Neubauer, 1992; Tricker, 1994; Lorsch & Carter, 2004).

The practical question could also be 'why?' Why should boards be paralysed within the instrumentalist perspective if it renders the board irrelevant? Why should boards focus on the selfishness and the opportunism of management if that is really not an issue or the most important role the board can have? Why should boards be structured and have integrated processes based on the assumption shareholders are so dispersed they cannot control the organisation, when the opposite is true in far more cases? (La Porta et al., 1999; Lubatkin, 2007). The answer is 'they should not,' if the premise of corporate governance is boards should have value as organs within the organisation.

The history of the board in organisations has shown it has been traditionally somewhat lost if it only had a formal and ceremonial role (Herman, 1981; Mace, 1971; Vance, 1983). Those boards didn't function (Drucker, 1974). This might seem strange, when in the words of Drucker (1954, p. 178), "to the law, the Board of Directors is the only organ of the enterprise. [. . .] Legally it is considered the representative of the owners, having all the power and alone having power." In other words, it is in the hands of the board, in their power, to decide what the role of the board is to be. Directors have responsibility, as well as the power to decide what to do with that responsibility.

The results of this research have showed that board can and do have more than one role and are far more active in strategy than often is assumed. This conclusion was reached by studying SMEs in Iceland. This supports the contingency perspective of 'one-size doesn't fit all,' indicating boards determine their own value. This conclusion is similar to that reached by Lorsch and Carter (2004) after studying large leading corporations in North America and Europe. They argue (Lorsch & Carter, 2004, p. 61):

> We believe strongly that each board must define the value it will provide. It must explicitly choose the role it will play, and its choice must be informed by a good understanding of its company's specific situation and its own capabilities and talents. Defining its role is the first step in effective board design. It is as important as laying a foundation before a house is built.

The conclusions reached in this research seem therefore not only to apply to SMEs in Iceland. There seem to be global similarities not affected by size of organisation. The emphasis on the board's freedom to choose its role is based on the contingency perspective rather than institutionalism. Directors need to understand the board as an organ in an organisation, as well as becoming 'professionals' and 'activists' (MacAvoy & Millstein, 2003). The value of the board as an organ and the value of the whole organisation may be determined by the foundation the board itself chooses to build.

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