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Governance strategy: Turning governance into action

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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 a riding school in a democratic not-for-profit association and the organisation of multinational corporations in a business group.

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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 practice, especially in the United States and in United Kingdom, and especially concerning the governance problems of their 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 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. For example, even though observing only listed corporations, Faccio and Lang (2002) found that the frequency of family-controlled listed corporations was 65% in Italy, 60% in Germany, and only 24% in the UK. Cescon (2002) claims that the prevalence of single strong owners is one explanation to the findings that Italian firms experience less pressure towards short-termism behaviour than do firms in the UK.

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 and 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 action-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 the governance strategy model.

Accordingly, we start by outlining the conceptual development of governance strategy (section 1), then apply it (in section 2) to two organisations — 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 an action-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 and 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.

Insert figure 1 about here

The model is built on a conception of property rights, implying that property rights are allocated to the principal and the agent, as indicated in Figure 1, and that the set of property rights differs among organisations. 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. This area of freedom of action is the very basis for an action-oriented conception of CG. Simply put, without any opportunity for strategic action, CG would have no action implications.

1.1 The principal

Exploring the model of governance strategy in more detail, we start with the actor of governance, 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 (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.

Alchian and Demsetz (1972) suggested that the single proprietor/principal of the classic firm had one specific bundle 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 with shareholders and not-for-profit democratic associations based on membership, suggesting a different distribution of property rights between the principal and the agent. For example, in the corporation the residual right and the right to sell the rights of the shareholder both belong to the shareholder, but in the not-for-profit association the residual right belongs to the organisation, and membership is not for sale. A shareholder can profit from an innovation in the corporation by capitalising the market value of the residual rights, for example through selling the rights on the stock market. A member has to profit from an innovation through being present in the organisation and using the service produced by the organisations. Thus, the difference in these two specific property rights produces quite different incentives and behaviour.

These bundles of property rights allocated to different actors have evolved throughout history for economic and political reasons; they have been institutionalised and ultimately codified in the laws of the State. Important to our purpose, i.e., describing a principal's use of a governance strategy, is that different organisational forms distribute different bundles of property rights to the principal, thereby implying differences in both the interest and capacity of the principal to design a governance strategy. Thus, in order to understand the governance strategy of an organisation, the bundle of property rights assigned to the principal have to be acknowledged.

1.2 The agent

An agent can be defined as the party responsible for the implementation and fulfilment of the will of the principal. In fact, CG can be defined as those structures and processes that intentionally and /or functionally 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, 1985). 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 (a) the nature of the principal, due to an ambiguous principal or limited information about the principal or (b) the goal of the principal, due to numerous principals with differing goals, ambiguity of goals (e.g., due to a principal with fast-changing goals), or limited information about the goals. For example, in a listed corporation with a high turnover of shares on the stock market, the makeup of dominant shareholders could change quickly, making for ambiguity of both the character and goals of the currently dominant principals. Adopting the limited rationality assumption seriously, one has to acknowledge that goal deviance could be caused by the managers acting according to stewardship theory (Davis, Schoorman, and Donaldson, 1997), i.e., with the spirit of implementing the will of the principal, but according to transaction cost theory (Williamson, 1985) being imperfect both in information and 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 the entrepreneurial actions of managers, by which is meant both implementation of strategy and strategic opportunism, i.e., changing the strategy in a creative way. There is a tendency in the CG literature to focus on the implementation part, and to conceive the developmental part as a deviance that has to be restrained. While corporate governance mainly is focused on monitoring strategy implementation, the field of corporate entrepreneurship has been devoted to conceptual development of strategic opportunism notions. Thus, strategic opportunism signifies the capacity to perceive new opportunities and to develop new strategies, be they new products or markets, and to be capable of redirecting corporate resources (Covin and Slevin, 1991; Zahra, 1996; Zahra and 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 entrepreneurial action 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

A governance strategy is defined as the principal's plans and actions for designing single CG mechanisms and determining the mix of CG mechanisms. In order to understand the strategy, we need to know the mechanisms of governance and the principal's interest in and capacity to engage in a strategy. This section is devoted to the mechanisms and the next section focuses on the principal. In this section we list the corporate governance mechanisms and describe their exposure to strategic action. It is particularly important to note that (a) board mechanisms can be interpreted as constituting an arena where the principal is defined and acknowledged, and (b) phenomena that have been interpreted as governance failures, such as the diversification wave and executive compensation, can be seen as parts of governance strategies related to the entrepreneurial capacity of managers.

Governance strategy is shaped by the mechanisms of corporate governance. A widely accepted list of mechanisms has evolved which are considered to have a decisive influence on the manager of the organisation (Schleifer and Vishny, 1997):

- The market for capital, be it equity or debt, observing for example capital rationing (Berglöf, 1990) and the incentive effects of the capital structure (Jensen, 1993);
- The market for managerial labour, observing for example external supply and the socialisation effects of internal recruitment (Ouchi, 1980);
- Executive compensation, observing for example levels and forms of compensation (Gomez-Mejia and Wiseman, 1997; Tosi, Werner, Katz, and Gomez-Meija, 2000);
- The board of directors, observing for example composition and work rules (Dalton, Daily, Ellstrand, and Johnson, 1998);
- The auditors, observing for example the choice of audit bureau (Inchausti, 1997);
- The strategy and structure of the organisation and its interplay (Chandler, 1962);
- The product market, especially its level of competition; and finally

- The organisation’s environment, including for example mass media, national culture, regulations by private or public bodies, and state legislation (Lubatkin, Lane, Collin, and Very, 2005; Watts and Zimmerman, 1986).

The mechanisms are to a certain extent determined by exogenous forces, which set decisive limits on the governance strategy. 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. 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). 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 appears to be entirely exogenously determined. Thus, an actor of governance, within the restrictions of property rights and corporate mechanisms, can use the power of property rights and the leeways of the different mechanisms to direct the organisation towards the will of the principal, i.e., to create a governance strategy.

The mechanisms are fairly well described in the literature and need not be reviewed in detail at this point. We do need, however, to stress the board of directors since this mechanism highlights our claim about the agency problem of principal identification. Additionally, we emphasise our intent to integrate the entrepreneurial actions of strategy implementation and strategic opportunism into the model of governance strategy. With this aim, we will present a slightly different interpretation of the direction of two governance mechanisms, that of *capital structure* and *corporate strategy*.

The board of directors has been found to have three functions: control, decision making, and service (Golden and Zajac, 2001; Zahra and Pearce, 1989). Yet this is a limited view of the board. 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 provide 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, the voluntary organisation, the membership association, and 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 an important device for an ambiguous principal to indicate its presence and its will.

If we wish to include entrepreneurial activity and capacity through strategy implementation and strategic opportunism within the governance strategy concept, then CG mechanisms can be interpreted in another light. For example, capital structure is an important mechanism in many corporations, especially in corporations where the principal has strong financial goals. According to the pecking order theory (Myers and Majluf, 1984), internally generated equity, i.e., profit, is preferred over debt, which is preferred over externally generated equity through share issues. One interpretation of this order is that it represents the descent of managerial autonomy, and is thus an indication of agency problems in the firm. An alternative interpretation, stressing the entrepreneurial aspect of governance strategy, is that the order represents the amount of disclosed information needed, i.e., how much information the firm needs to disclose and thereby face the risk of informing its competitors. Thus, financing through retained earnings, which could be expected to appear in highly R&D-intensive corporations, could represent a part of a governance strategy where the principal avoids distributing sensitive information.

The strategy of diversification can also be interpreted differently when using the concept of governance strategy. It has been claimed that diversification and the corresponding M-form structure was merely a strategy of 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 and Lev, 1981, cf. Lane, Cannella, and Lubatkin, 1997). Another interpretation along the lines of a governance strategy could, however, be put forward. First, one has to realise that the (beta) risk of the diversified shareholder 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 risk aversion is not a matter of feeling hurt when high variance is experienced, but when black numbers turn into red. Diversification was 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 over several years could be absorbed by the diversified corporation, making the total outcome of the organisation a positive one. Thus, diversification is not about avoiding risk as variance but risk as probability of loss.

Summarising this section, we have claimed that the principal can influence corporate governance mechanisms to an extent determined by exogenous forces, and in doing so can influence the agent's entrepreneurial capacity to implement the strategy and to creatively develop it through strategic opportunism — 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 entrepreneurial action, stimulated and restricted by the governance mechanisms. We now turn to the principal and the principal's interest in and capacity to engage in consuming resources for the sake of designing a governance strategy.

1.4 The principal's interest and capacity

The principal's choices in creating a governance strategy involve at least two factors: the interest of the principal, i.e., the incentive to engage in creating a strategy, and the capacity of the principal, i.e., the ability to create and to enforce a strategy (Figure 1).

A principal's interest can be divided into the strength and the direction of the interest. 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. Thus, efficiency is a function of the principal's interest. Interest could, however, as previously noted, be manifold due to there being numerous principals, as for example in the case of shareholders with different views on the appropriate strategy of the corporation and having different risk attitudes. The implication of numerous principals 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 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 Fiat has a strong legitimate claim, based on the property rights of the joint stock company, but will presumably spend very little effort on putting forward its interest since the expected benefits are low compared to the effort needed. Accordingly, we cannot expect the formation of a governance strategy from that person. The suggested concept of strength of interest contains the economic argument that an individual will not act if the benefits earned are considered to be lower than the costs of effort. Legitimacy is added since the model is based on a property right conception, where rights regulated in society by laws, norms, and traditions constitute the capacities of the economic agents (Reynolds, 1983). While legitimacy tends to be unproblematic in the case of share ownership, it could be a decisive factor when an individual puts forward an interest with support of a coalition of members in an association, or when strength is built on other bases of legitimacy than share ownership, such as professional knowledge, networks, or authority (cf. DiMaggio and Powell, 1983).

Having an interest is a necessary but not a sufficient condition for a governance strategy. A principal needs to be able to design and implement a governance strategy. Assuming it to be a rational process, the capacity of the principal will be influenced by information, competence, and the costs of governance. Information is needed about the organisation, its environment, and about the mechanisms and their accessibility for strategic action. Competence is the ability 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 possession of information and the capacity to make productive use of it, i.e., competence. This conception can be regarded as realistic, though not in accordance with agency theory, which assumes asymmetric information to be the cornerstone of the conflict between the principal and the agent (Jensen and Meckling, 1976). The claim made by the concept of capacity of the principal is that an asymmetric distribution of competence produces similar problems of governance as the information asymmetry. Thus, while one means of reducing agency conflicts is to manage information, another means is to educate and inform the parties about the theories and models that constitute their competencies.

Finally, governance costs represent the consumption of resources needed in order to gain information and competence, and to have the ability to enforce the strategy. Enforcement of a strategy includes the use of property rights, including efforts of creating legitimate and credible rights through private ordering (Pagano, 2000) in the case of less well defined property rights (Foss and Foss, 2005), or to create coalitions capable of collective action (Thompson and Davis, 1997) when several principals are present. 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 who 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 are not independent factors since strength of interest would induce higher governance costs, i.e., having made a large investment or being strongly dependent on the organisation would induce the principal to assume high governance costs in order to protect the investment and defend the dependency (Williamson, 1985).

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 a manager's entrepreneurial action, including strategy implementation and strategic opportunism. The model thereby indicates the prerequisites for a principal's strategic action and the mechanisms that can be part of the governance strategy.

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 managers entrepreneurial action is especially in need of conceptual development. However, we have confined this section of the paper to the conceptual development of governance strategy. In the next section of this paper we turn to an illustration of governance strategies through case studies of two organisations. Through describing and analysing the organisations using the concepts developed above, we find indications of the relevance of the model.

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. CG research has mainly been devoted to large listed corporations, as indicated in the introduction. In order to find indications of the relevance of governance strategy in two different types of organisation we selected an Equestrian Association (EA), which is a riding school organised as a democratic not-for-profit association (i.e., without 'ownership') where the main objective is to produce a service; and a Business Group (BG), which is a constellation of large listed corporations joined in a network through ownership where the main objective is long-term profit.

There are two main reasons for the selection of the EA and the BG:

(a) Probability of an identifiable and active principal. Since our approach is action-oriented, we chose organisations where the principal can be expected to be active, and whose actions can be interpreted as constituting a governance strategy. This selection is intended to illustrate the concept but does not exclude the possibility that a governance strategy may be

applicable within listed corporations. Indeed, examples of proxy contests and hostile takeovers could be used as indicators of actors of governance applying a dramatic governance strategy within listed corporations.

(b) Generality of CG concepts: Since CG research has created general knowledge, but mainly applied it to large, capitalistic listed firms, it is appropriate for the sake of data variety in the field and for the sake of the robustness of the general corporate governance concepts to apply them in less frequently observed organisations, such as EAs and BGs. Indeed, if the concept of governance strategy is the conceptual contribution of the paper, the selection of case organisations outside the normal realm of corporate governance could be regarded as an empirical contribution to the literature.

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 and Smith (2007) 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 description is therefore systemised according to the concepts of the model. The relevance of the model is indicated through describing each of the organisations separately with the use of the model, then providing a comparative analysis that will create 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 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 Equestrian Association

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 yearly membership fee (about €10), 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 appears to be generally modest in intensity. One reason for this impression is that the character of the principal is uncertain, since the existence of members who can and will assume the high governance costs is somewhat random, and members tend mainly to appear when they are dissatisfied. Many mechanisms are modestly utilised, such as equity and debt, since they tend to be very small or even absent. The managerial labour market is thin, the supply of managers low in number, since small organisations 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, the board 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 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 equestrian 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 can be expected to have superior information compared to other investors. 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 relatively 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 appears to be rather intense, mainly because the group appears to utilise almost every mechanism. Equity may be the most modest 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 of the board and the CEO. 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 has always had several directorships on the different corporate boards. Often they even hold the position of chair. 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 quite 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 actions 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, reputedly the 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 General Motors. 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 1850s 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 subjective codification of the organisational 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 level of strategic opportunism have been interpreted as low, moderate, or high. 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.

Insert table 1 about here

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 150 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 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 the manager's entrepreneurial actions, especially strategic opportunism. As indicated by the summary of ratings at the foot of Table 1, the EA is characterised by a governance strategy with an overall moderate emphasis and utilisation of the different mechanisms, but with a great variety, mainly utilising the board of directors and the external managerial labour market.

The BG appears to exist in a different kind of environment where the exogenous forces are quite 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 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 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.

A final observation has to be made about the momentum of mechanisms. All mechanisms have a variety of functions, not limited to governance, e.g., the market for capital has the additional function of financing and risk distribution. The board of directors at the EA also has coordinative functions, and the internal market for managerial labour in the BG has had the function of retaining managers when there was a shortage of managers in the external market for managerial labour. This multiple use of the mechanisms could be one reason why they are used today in governance. In other words, a mechanism has gained a momentum that makes it available for solving problems other than the original one (Hughes, 1994).

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; a limited capacity to mix many mechanisms will induce even stronger emphasis on the available mechanisms, and finally, utilisation of a mechanism could be due to the momentum of the mechanism, constituting an investment available for the usage of governance.

3. CONCLUDING REMARKS ABOUT GOVERNANCE STRATEGY

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

The model of governance strategy emphasises property rights and 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. It has been indicated that 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 rights. 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, however, not limited to researchers, but the action 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. Indeed, the efforts of the agent in order to identify the principal have been stressed.

The model emphasises the interest and the capacity of the principal to design a governance strategy; factors have been identified that can be expected to influence the interest and capacity of the principal. Competence attainment has been added to the agency theory focus on information, and the notion of governance costs stresses not only transaction costs in a limited sense, but includes also efforts to influence the credibility of property rights. The model is highly general in order to be able to fulfil the aim of being applicable in organisations with a separation of property rights concerning control and execution, at the cost of being less capable of making specific predictions.

The model emphasises strategy implementation and strategic opportunism, which makes it possible to understand actions made by agents as not only opportunistic for the sake of the agent, but also strategically opportunistic for the sake of the principal. Additionally, linking governance to both implementation and strategic opportunism transforms the focus of governance from restrictive discipline to enabling development.

The two empirical cases have shown how the mechanisms have been used in two different settings. It was found that the capacity and interest of the principal appear to influence the governance strategy, which is in accordance with the model, thus indicating the relevance of the model. While it may be presumptuous to convert our comparative analysis based on anecdotal observations into theoretical propositions, the analysis suggests that (a) the exogenous influence does not appear to put a limit on the principal's capacity to utilise a governance strategy, but only puts a demand on the intensity with which the principal uses the mechanisms; (b) a limited capacity to influence several mechanisms and to mix many mechanisms will induce even stronger emphasis on the available mechanisms; and finally, (c) utilisation of a mechanism could be due to the momentum of the mechanism.

The aim of the paper has been to present a conceptualisation of corporate governance based on strategic choice. This is accomplished through the model of governance strategy. While the relevance of the model can be found in its capacity to be descriptive and to create an understanding of processes, structures, and events, the goal of an action-oriented model is to be used for stimulating or evaluating action. A principal could use it 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 capacity of the environment and the agents 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.

An agent could use the model 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.

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 "box" in Figure 1 labelled 'Strategy Implementation & Strategic Opportunism' 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.

On the empirical side, the model could be tested by applying it to a sample of empirical cases. More importantly, considering its action orientation, is whether the model stands the test of reality and can be used not only to describe and understand, but also to perform 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 assigned to perform 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.

A final remark concerns the notion that our model of governance strategy is based on a conception of property rights defining a principal and an agent. As we have found, a principal can vary in many respects, as for example the right of the residual being possessed by the shareholder in the corporation and possessed by the organisation in the case of a not-for-profit association. The right to alter the parties of the firm, especially the top manager, appears however to be a property right that is an invariant characteristic of a principal. This characteristic makes the agent dependent on the principal since the agent's contract relies on the principal's decision to continue the contract based on the principal's experience of the performance of the firm. Thus, the agent is made accountable for the performance of the firm (Sternberg, 1997), with the agent's contract at stake.

The explicit focus on the principal in the proposed model of governance strategy can be contrasted to the stakeholder theory that proposes that anyone with legitimate claims and power to influence the corporation is a stakeholder (Agle, Mitchell, and Sonnenfeld, 1999). The model has been criticized for being too broad, lacking any capacity to discriminate and therefore to explain the setup of corporate governance mechanisms (Grandori, 2004). While this has some general truth, there have been attempts to create a theory with more discriminating capacity, such as that of Mitchell, Agle, and Wood (1997) who suggest that power, legitimacy, and urgency of claims influence the salience of a stakeholder. This stakeholder theory has been tested empirically with some success (Agle, Mitchell, and Sonnenfeld, 1999).

There are, however, distinctive differences between the stakeholder theory and the model of governance strategy. The stakeholder theory focuses on the top managers and their experience of parties in the environment and the organisation. It is how managers conceive the impact a party has on the organisation, not on the manager's contract, that creates the salience of the stakeholder and the need to manage the relationship through accommodating the claims of the stakeholder. With this focus, it is a theory of strategic management, not of corporate governance. Indeed, it could be claimed to be the scientific heir of the Berle and Means prophecy of the corporation when the owners have been kicked out of the saddle: "*It is* *conceivable – indeed it seems almost essential if the corporate system is to survive, - that the ‘control’ of the great corporations should develop into a purely neutral technocracy, balancing a variety of claims by various groups in the community and assigning to each a portion of the income stream on the basis of public policy rather than private cupidity*” (Berle and Means, 1947:356). The model of governance strategy puts the owners back in the saddle, but now as possessors of property rights, offering them the opportunity to design and implement a governance strategy.

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Figure 1. Governance Strategy

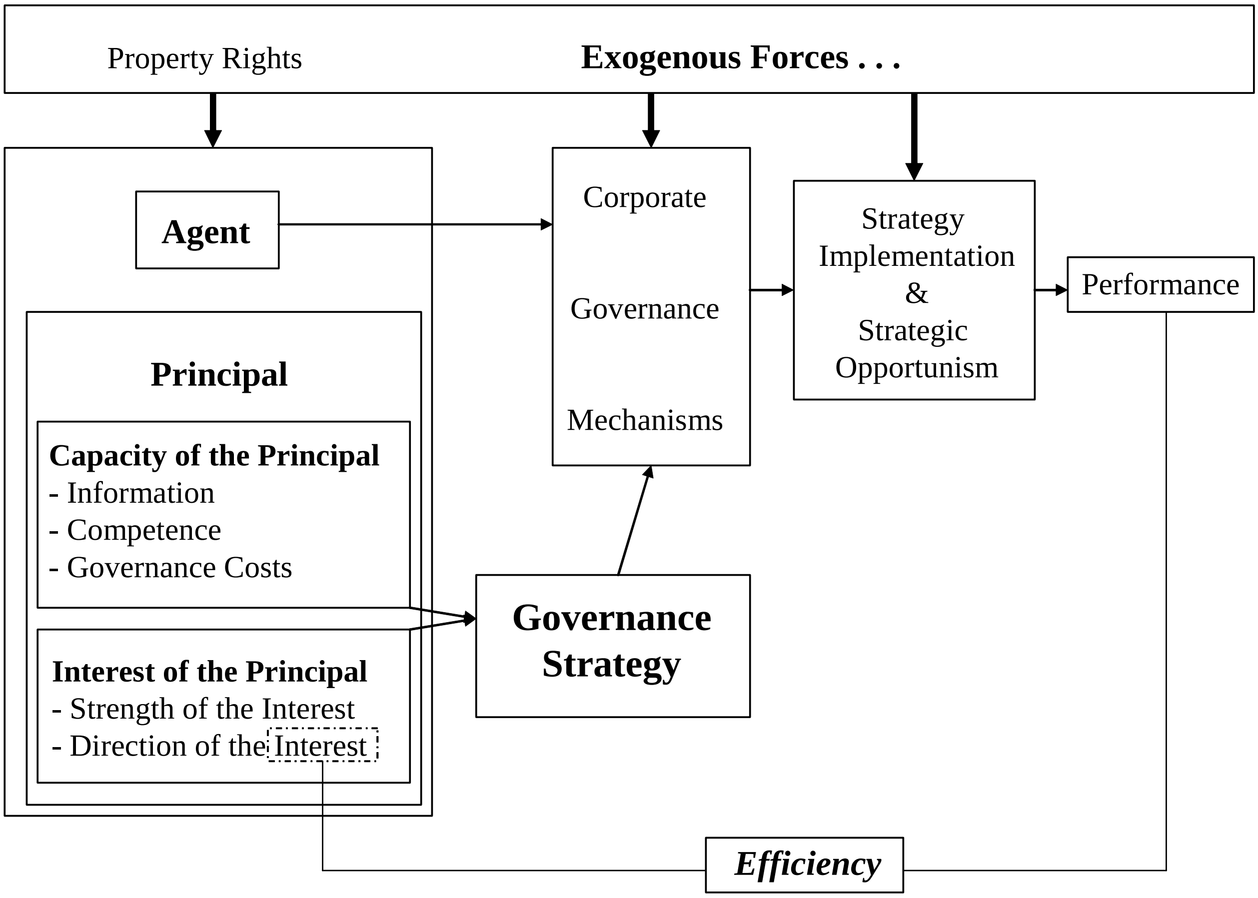

Table 1. Comparison of Two Organisations

	Equestrian association		Business group	
	Exogenous influence	**Strategic action**	**Exogenous influence**	**Strategic action**
Capacity of the principal				
Information		moderate		high
Competence		low		high
Governance costs		high		moderate
Overall assessment of capacity		*low*		*high*
Interest of the principal				
Strength of the interest		moderate		high
Direction of interest		Service		Profit
Governance mechanisms				
Market for capital				
Equity	low	low	high	moderate
Debt	low	low	high	high
Market for managerial labour				
External	low	high	high	moderate
Internal	low	low	low	high
Executive compensation	low	moderate	high	high
Board of directors	low	high	moderate	moderate
Auditors	low	low	high	moderate
Strategy	high	low	moderate	high
Structure	low	moderate	moderate	high
Product market	moderate	low	high	moderate
Overall	*low*	*moderate*	*high*	*high*
Variance	*low*	*high*	*moderate*	*low*
Strategic opportunism		moderate		moderate