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Corporate Governance and Strategic Change in SMEs: The Effects of Ownership, Board Composition and Top Management Teams

*Olof Brunninge**
Mattias Nordqvist
Johan Wiklund

ABSTRACT. This paper investigates how governance mechanisms affect the ability of small- and medium-sized enterprises (SMEs) to introduce strategic change. Previous research typically assumes that governance mechanisms operate independently of each other. Building on agency theory and insights from the literature on small firm governance, we hypothesize that governance variables related to ownership, the board of directors and the top management team all affect strategic change and that it is important to examine the interaction effects of these governance mechanisms. Using a longitudinal sample of over 800 SMEs, our general logic and hypotheses are supported by the analyses. We find that closely held firms exhibit less strategic change than do SMEs relying on more widespread ownership structures. However, to some extent, closely held firms can overcome these weaknesses and achieve strategic change by utilizing outside directors on the board and/or extending the size of the top management teams. Implications for theory and management practice in SMEs are discussed.

KEY WORDS: corporate governance, small- and medium-sized enterprises, strategic change

JEL CLASSIFICATION: L26.

1. Introduction

Over the last 15 years corporate governance has become one of the most common terms in business and finance discourses (Keasey et al., 2005). Corporate governance is associated with the defense of shareholders' interests by the use of firm governance devices (Johnson and Greening, 1999; Shleifer and Vishny, 1997; Short et al., 1999). It can be broadly defined as the exercise of power over corporate entities (Tricker, 1997). Contemporary corporate governance literature is very broad. It covers a number of issues with a shared focus on the relationship between owners, board of directors, top management teams (TMTs) and CEOs, as well as the remuneration of executives at different levels (Keasey et al., 2005; Monks and Minow, 2004; Tricker, 1996). A problem with governance research is that with few exceptions, studies have investigated one type of governance mechanism, most commonly the board, while excluding others (e.g., Daily and Dalton, 1993; Forbes and Milliken, 1999; Johnson et al., 1996; Rediker and Seth, 1995; Zahra and Pearce, 1989). Especially, the notion of corporate governance as dealing with the interaction between a firm's ownership, board and top management has not been sufficiently explored in the literature (Monks and Minow, 2004; Tricker, 1996). In this paper, our aim is to take a step towards overcoming some of these shortcomings by examining how different governance devices operate and interact to promote small- and medium-sized firms' (SMEs) ability to change strategically.

The ability of an organization to change its strategy in line with evolving and changing internal capabilities and environmental conditions is a key outcome variable of governance research (Goodstein and Boeker, 1991; Pettigrew, 1992). Despite this, most studies have focused on explaining aspects of financial performance, while few have examined how the broader governance structure of the firm affects strategic

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*All three authors have contributed equally to the paper. Their names are listed alphabetically.

Olof Brunninge, Mattias Nordqvist and Johan Wiklund
EMM,
Jönköping Intl. Business School,
Jonkoping, 55111, Sweden,
E-mail: brol@jibs.hj.se

change (Goodstein and Boeker, 1991; Goodstein et al., 1994; Pettigrew, 1992). Research focusing on performance does not take into account that governance choices have to result in action, such as strategic change, before they can have performance implications. Further, in an SME context, the use of performance as a dependent variable is problematic due to the multitude of goals that usually prevails in such firms (Wiklund, 1998). Concerns for employee well-being and/or the welfare of the owner-family may be of great importance to small business managers (Wiklund et al., 2003), which renders other dependent variables, such as strategic change, appropriate.

SMEs are likely to meet specific challenges regarding governance and strategic change. In recent years, governance research has extended from large firms to studies of SMEs (Huse, 2000). While this literature has provided valuable insights into different governance forms and mechanisms, it shares the simplistic view that different governance mechanisms operate independently of each other (cf. Rediker and Seth, 1995). This is a particularly serious shortcoming in studies of SMEs, because many of these firms are closely held and governance issues are more entwined than in large, publicly held firms where the separation of ownership and management is more clear-cut (Cowling, 2003; Schulze et al., 2001, 2003). This means that in SMEs ownership, board, and top management often overlap, with the same people, or people from the same family, involved at all levels (Mustakallio et al., 2002; Nordqvist and Melin, 2002). Therefore, governance research would benefit from research that disentangles ownership, board and management issues and investigates how these are interrelated in creating key organizational outcomes such as strategic change. This is where we make our contribution.

In the subsequent sections of this article we first generate and test hypotheses concerning the direct and interaction effects of different corporate governance variables on strategic change. We then present the methodology and analyses. After presenting and discussing our empirical results we conclude by outlining their implications of our findings for theory and managerial practice.

2. Theory and hypotheses

2.1. *Ownership*

Most SMEs are closely held and owner-managed (Bennedzen and Wolfenzon, 1999; Nutek, 2004). The concentration of ownership and the unification of ownership and management lead to managers being subjected to less pressure from outside investors and other monitors who demand accountability, transparency and strategic renewal (Carney, 2005). Ownership concentration among the top management of the firm can lead to risk aversion and lack of willingness to engage in strategic change activities such as corporate diversification, product innovation or entering new international markets (George et al., 2005; Hill and Snell, 1988; Hoskisson et al., 2000).

Agency theory stresses that the extent of involvement in risky activities is likely to be influenced by the ownership and governance of the firm (Fama, 1980; Fama and Jensen, 1983; Jensen and Meckling, 1976). According to this theory, equity ownership influences managers' risk-taking propensity (Eisenhardt, 1989; Keasey et al., 2005; Zajac and Westphal, 1994), suggesting that managers become risk averse as their ownership in the firm increases (Beatty and Zajac, 1994; Denis et al., 1997). Strategic change typically involves taking risk. The concentrated nature of ownership puts closely held firms at a disadvantage in terms of risk bearing and promotes strategic inertia (Chandler, 1990; Meyer and Zucker, 1989; Schulze et al., 2002). This means that high concentration of ownership may lead to risk avoiding strategic choices (Chandler, 1990). Many closely held firms are also family firms. The blending of family and business matters in strategic decision-making may promote inertia in these firms, when for instance a CEO postpones necessary business decisions, such as a generational succession, for concerns about the family welfare (Schulze et al., 2002). These authors argue that family ownership impedes strategic change activities, such as innovation, venturing and strategic renewal activities, as a result of the risk aversion of the concentrated ownership, altruistic incentives and problems with self-control. There is also a stream in the

family firm literature that depicts these firms as conservative and resistant to change (Aronoff and Ward, 1997; Kets de Vries, 1993; Sharma et al., 1997), introvert (Poutziouris et al., 2004), paralyzed by internal family conflicts (Barach, 1984) and a defensive attitude harming longevity and efficiency (Carney, 2005).

Moreover, in closely held firms, owner-managers typically develop the strategy at the founding of a firm. Due to their personal involvement, this commitment to the strategy often continues over time leading to unwillingness to change the original strategy (Boeker, 1989; Kimberly and Bouchikhi, 1995). The longer ownership is concentrated to the same individual or a limited group of individuals, the more likely it is that owners unite around the same values, interests and strategic practices (Goodstein and Boeker, 1991; Tushman and Romanelli, 1985). "Over time, owners may become insulated from environmental and performance changes and fail to perceive and react to critical environmental and organizational changes" (Goodstein and Boeker, 1991, p. 312). Therefore, we hypothesize:

H1: Closely held SMEs exhibit less strategic change than other SMEs.

2.2. *Board composition*

Boards of directors provide the formal link between owners and the managers responsible for the day-to-day operations of the firm. The board has been described as the "apex of the firm's decision control system" (Fama and Jensen, 1983, p. 311). Most SMEs, however, are closely held and owner-managed and owners thus have direct and detailed insights into internal processes of the firm (Cowling, 2003). As a result, there is less need for the control function of the board and many SME boards exist on paper only (Brunninge and Nordqvist, 2004; Ford, 1988; Huse, 2000). However, there are also examples of SMEs having active boards with outside members, using the boards of directors as a means for strategy development (Fiegener, 2005; Ward, 1991). Outside members are more likely to view the tasks of the board as being distinctly different and complementary to that of management, while insiders may view board work as an extension of their managerial responsibilities (Forbes and Milliken, 1999; Mace, 1986).

Outside board members are not tied to the day-to-day operations of the firm and consequently they are likely to think more freely concerning the strategic alternatives open to the firm (Forbes and Milliken, 1999). Their experiences from contexts other than the firm also help generate new perspectives and ideas and can increase cognitive diversity. Cognitive diversity means the existence of multiple and different data collection, analysis and interpretation styles among the members of a group. Boards with active outside directors who have different information acquisition and interpretation styles, are likely to consider a wide array of data sources about their companies' markets, competitors, operations, and customers (Keck, 1997; Leonard and Sensiper, 1998). This could improve the odds that they participate in strategic decision-making in SMEs (Fiegener, 2005) and spot more needs and opportunities for strategic change.

Therefore, outside board members in closely held firms can point out new strategic directions but also provide information and advice during a change process (Borch and Huse, 1993). Drawing upon their personal contacts they can also link the company with important stakeholders in its environment (Borch and Huse, 1993; Zahra and Pearce, 1989), operating as agents for resource acquisition (Goodstein and Boeker, 1991) and enhancing the reputation and legitimacy of the organization (Hung, 1998; Johannisson and Huse, 2000; Pfeffer and Salancik, 1978), thus facilitating favorable external conditions for change. This leads to the following hypothesis:

H2: The presence of outside directors on the board has a positive effect on strategic change.

2.3. *Top management teams*

Agency theory suggests that top managers' inclination to change strategy is linked to the ownership structure of the firm (Bethel and Liebeskind, 1993). This is because managers'

wealth increases with growth and diversification, rather than through the total equity value of the firm. In SMEs, ownership and management are often unified, potentially making such behavior less likely. Turning instead to upper echelon theory, Hambrick and Mason (1984) posit that TMT cognitive characteristics, such as values, norms and interests, significantly influence the way that firms process and interpret information about their markets and customers, thus impacting also their ability to recognize and pursue strategic change. Previous research has investigated the characteristics of TMTs, most notably the relation between TMT demography and performance (Amason, 1996; Amason and Sapienza, 1997).

The effect of TMT characteristics on strategic change is likely to be particularly strong in SMEs because small size and flexible organizational structures intensify TMTs' involvement in all activities of the firm. For example, specialized departments for marketing and product development are less common in SMEs (Cowling, 2003) and, if they exist, their decisions are heavily influenced by top management. In this context, the shared strategic cognition is likely to include consensus among team members in terms of agreement on strategy (Floyd and Wooldridge, 1992). Strategic consensus can impact strategic change positively as far as the consensus supports an alteration in strategy (Amason, 1996; Amason and Sapienza, 1997). Ensley and Pearson (2005) suggest that TMTs with many members from the same family, that is, high degree of 'familiness' should mean more shared strategic consensus of the TMT as a result of altruism, loyalty and commitment. This is, however, not supported empirically in their study.

In many SMEs, top management consists of one person – the CEO, who is most often also the business owner. In such situations, an SME is reliant on the resources and skills of one person for its strategic leadership. Larger TMTs are likely to have more resources and skills available to them in decision-making. Larger size also increases cognitive diversity, adding perspectives available in strategy-making. Effective TMTs engage in cognitive conflict, defined as task-oriented disagreement arising from differences in perspectives (Amason and Sapienza, 1997). Moreover, TMT members are unlikely to have the same tasks, that is, they represent different functional areas of the firm's operations, which add to diversity. By increasing cognitive diversity a larger and functionally more varied group can increase creativity in decision-making and point to new alternatives for future development of the firm (Forbes and Milliken, 1999). In closely held firms, a larger TMT with more non-owner top managers may partly counteract the dominant influence on the strategic direction that the owner-manager otherwise has. Being one out of several TMT members, the individual member may feel more confident and safe to suggest alternative strategic ideas and to promote strategic change. Hence, a larger TMT should increase the willingness for change as well as the availability of options for carrying out change. Therefore:

H3: Larger TMT size has a positive effect on strategic change.

2.4. *The interaction effect of ownership and outside directors on strategic change*

There is a potentially important link between ownership structure, board of directors and strategic change (Goodstein and Boeker, 1991; Mustakallio et al., 2002). Fiegener (2005) found that the board is less likely to participate in strategic decisions in SMEs if the CEO is the majority owner. The reason, he argues, is that the owner-manager has power to influence strategic decisions and change in other ways that forestall the participation of the board. Interestingly, Fiegener (2005) does not find support for the hypothesis that boards' strategic participation is less likely when there is a larger group of family members of the CEO holding majority ownership. This suggests that a board with outside board members is likely to be more involved in strategic change in closely held firms with many active members of the owner-family compared to firms where there is only one owner who is also CEO.

It can further be argued that in firms that are not closely held, where ownership and management are separated, one important role for

boards is to safeguard shareholders' investments in the face of potential managerial opportunism, putting emphasis on monitoring and control. Outside directors are not familiar with the day-to-day operations of firms but instead reliant on information passed on to them by management. Opportunistic management can choose which information to divulge and which to contain, and whether to present accurate or biased information (Hoskisson et al., 1994). As a result, outside directors tend to rely more on financial evaluations than on strategic evaluations because such information is less ambiguous and unlikely to be biased. Consequently, strategic governance is likely to be low and managers are evaluated more on financial outcomes (Baysinger and Hoskisson, 1990). In closely held firms the role of the board is different, because the risk of opportunistic behavior by management is lower (or zero). The board can therefore focus less on control and more on service activities, such as on stewardship and strategic development. Above we argued that outside directors had a positive effect on strategic change in SMEs. In line with the reasoning in this section, this positive effect is likely to be stronger in closely held firms, where outside directors can focus more on stewardship and strategic development than in firms where the board has a stronger focus on monitoring, control and financial evaluations. This suggests the following interaction of ownership and outside directors:

H4: The presence of outside directors has a stronger positive effect on strategic change among closely held firms.

2.5. *The interaction effect of outside directors and the TMT on strategic change*

Formally, the board and the TMT are separate entities of an organizational structure, where the TMT and its CEO are responsible for the everyday operations of the firm. The relationship between the board and the TMT in SMEs is likely to depend on their compositions. As argued above, larger TMTs are likely to have more skills and abilities to draw upon in identifying needs and paths for strategic change. Greater size makes boards more independent (Cowling, 2003; Rindova, 1999) and leads to greater information processing ability which is advantageous in the complex decision-making that strategic change entails (Forbes and Milliken, 1999). Similar arguments were provided for the positive effects on strategic change by the presence of outsiders on the board of directors – outside directors increase cognitive diversity which facilitates greater chances of spotting needs and opportunities for strategic change. In an SME, the board of directors can be actively involved in strategy-making, but many SMEs lack an active board with outside members. Therefore, SMEs can draw upon the resources of the board as well as the TMT in decision-making. However, if there are no outside directors on the board, it may develop a myopic and narrow view of the firm, stalling strategic change. In such cases, the ability of the TMT to internally generate different viewpoints and options for change becomes increasingly important.

Moreover, one of the board's key roles is to monitor and control top management (Johnson et al., 1996; Zahra and Pearce, 1989), which includes giving voice in strategic decisions (Fama and Jensen, 1983). The board is more likely to be active and play this role with outside members (Cowling, 2003; Gersick et al., 1997). In this situation, the board may constrain and limit the room for strategic change initiatives of the TMT. For instance, when the CEO and/or the TMT suggest strategic changes they may face resistance if these changes are not in line with the interests and priorities of board members (Goodstein and Boeker, 1991). Conversely, where there is no active board with outside members performing the control and monitoring role, the CEO and TMT can be expected to have a freer role regarding strategic actions. In other words, the reliance on the TMT as an engine for strategic change is likely to be stronger in firms that have no outsiders on the board of directors, because its room for strategic action is increased. This leads to the following hypothesis:

H5: The size of the TMT has a stronger positive effect on strategic change when there are no outside directors.

3. Methods

3.1. *Design and sample*

According to OECD (2002, p. 193), more than 99% of all firms in Sweden can be classified as SMEs. SMEs account for 57% of the value added and 66% of net investments in the country and in 2000 three out of five employees in the private sector in Sweden worked for SMEs (OECD, 2002). Governance systems differ across countries. The Swedish corporate governance system combines characteristics of both the Anglo-American and the German systems (Fredborg, 1992; Jonnergård and Kärreman, 2004) Like the Anglo-American approach, Swedish corporations have a one-tier board. However, executive directors are very rare. Usually, the CEO is the only executive on the board. On the other hand, similar to Germany, employees are entitled to be represented on the board. Firms with less than 25 employees are exempted from this rule.

Given these facts, we collected data by surveying a sample of Swedish SMEs. The sample was stratified according to the following criteria: (a) four industrial sectors based on ISIC codes (manufacturing, professional services, wholesale/retail, and other services); (b) employment size class divided into two groups (10–49, 50–249, which is equivalent to the EU definitions of small- and medium-sized businesses, respectively); and (c) ownership (independent firms and members of business groups). The sampling population contained 2,455 firms obtained from Statistics Sweden (the Bureau of Census). We collected data using telephone and mail surveys targeting the CEOs of the SMEs.

We collected data for the study's independent and control variables in 1997. We collected data for the dependent variable strategic change in 2000. The three-year lag was chosen for two primary reasons. A lag between independent and dependent variables helps safeguard against the potential of reverse causality. It also takes time for strategic change efforts to materialize, suggesting that a substantial lag between independent and dependent variables is needed (Melin and Hellgren, 1994; Pettigrew and Whipp, 1991).

To collect data we contacted the firms by telephone and obtained 2,034 responses (82.9%). Shortly thereafter, all firms interviewed were sent a mail survey, generating 1,278 responses after two reminders, for a response rate of 52.1% of the original sampling population (2,455). In 2000, firms that responded to the 1997 survey were contacted again for a telephone interview for the dependent variable. *T*-tests to check for response bias did not reveal any significant difference between respondents and non-respondents for the telephone and mail survey data collection efforts on age, size, and industry distributions. The final sample with data for 1997 and 2000 was 889 firms (36% of original sample; 70% of 1997 survey respondents).

3.2. *Variables and measures*

3.2.1. *Dependent variable*

We subscribe to a broad view of *Strategic Change*. Strategic change is a process involving most parts of a firm and its relation to the environment, and thus a comprehensive scale is needed for its measurement (Johnson, 1988; Melin and Hellgren, 1994; Pettigrew and Whipp, 1991). From this perspective, strategic change can be both reactive and proactive, relate to both market and product issues and concern both internal organizing and external competitive strategizing. Most empirical studies on governance and strategic change take a much narrower approach. They typically conceptualize strategic change as either the change from one generic strategy to another, that is, using typologies of strategic orientation (e.g. Boeker, 1989), or only include service additions, divestures and/or industry changes (e.g. Golden and Zajac, 2001; Goodstein et al., 1994). This, we argue, gives a too simplistic and limited view on strategic change. Consequently and consistent with our theoretical conceptualization, the operationalization of strategic change includes changes to the internal organization of the firm (items h, i [cf. Mintzberg et al., 1998]), its markets, and products (items c, e, f, g, j, k [cf. Ansoff, 1965]), retrenchment (items a, b, c, d [cf. Robbins and Pearce, 1992]) and proactive

actions (items l and m [cf. Melin and Hellgren, 1994]).

Specifically, we asked if the firm over the last year had introduced changes along 13 dimensions, with a dichotomous yes/no response format. The index was measured as the sum of 13 items, each indicating a significant measure representing strategic change. The items included were: (a) conscious staff reductions; (b) major cost reductions; (c) cutting down, selling or closing down ineffective businesses; (d) introducing more sophisticated cost control systems; (e) starting doing business with a country the company had previously not done business with; (f) starting business in a new place within Sweden; (g) starting marketing oneself in a new way; (h) carrying out a considerable change of the company's organization; (i) carrying out a considerable change in the company's internal operations; (j) introducing an important new product or service or in any other way substantially changing offerings to customers; (k) commencing the development of a new important product, service or similar, which has not yet been introduced; (l) carrying out measures in advance that the company otherwise would have been forced to do sooner or later; and (m) carrying out changes particularly in order to get ahead of competitors.

The Cronbach's Alpha of the scale was 0.75, suggesting that firms indeed change along several dimensions simultaneously and that the reliability was sufficient to be summed to an index (Nunnally, 1967). While summing dichotomous variables to indices and computing Cronbach's Alpha may be less common, it is recommended in the psychometrics literature (e.g. Nunnally and Bernstein, 1994). In order to ensure that our results were robust to different operationalizations of the dependent variables, we tested several slightly different versions of this variable. Results were virtually identical, suggesting that our operationalization is robust.

3.2.2. *Independent variables*

A dichotomous variable was used indicating whether or not the firm was *Closely Held*. We regarded an SME to be closely held if its ownership was limited to the following ownership categories: the CEO; his or her immediate family (spouse, children, parents); board and/or TMT members. We argue that these firms lack clear separation of ownership and management. Approximately 35% of the sample was closely held. The definition includes as closely held: owner-managed firms, family businesses, and incorporated partnerships. Investment companies and parent companies were the most common forms of ownership among the remaining firms. Both these categories have clear separation of management and ownership. As our main focus regarding ownership in this paper lies on the question whether a firm is closely held or not, we did not further distinguish between the different types of ownership among the firms that were not closely held. We leave this task for future research.

To tap the presence of *Outside Directors* on the board we asked if there were any members of the board who neither worked for the company on a daily basis nor belonged to the main owner family. Close to half the sample had no outside directors on the board. For those that did, one outside director was most common. Because of this skewed variable distribution, we dummy coded the variable "0" for those firms that had no outside directors and "1" for those that did. The *TMT Size* was measured by first asking: "does the firm have an active decision-making top management team." If the answer was yes, we then asked how many persons were members of the TMT. In cases where there was no TMT, we coded this variable "1" indicating that the TMT consisted of the CEO only.

3.2.3. *Control variables*

During its life cycle a firm may become stuck in its paradigm and fall victim for strategic drift (Johnson, 1988). However, there are also indications that mature businesses can be rejuvenated. Therefore, we controlled for *Firm Age* asking what year the firm was founded, recoding the response into number of years. Governance and the ability for strategic change may depend on *Firm Size*. Therefore, we included the total number of employees of the firm as a control variable. *Entrepreneurial Orientation* (*EO*) was included as a control variable because previous research has found that a firm's degree of entrepreneurial orientation can profoundly

impact its ability for strategic change (Lumpkin and Dess, 1996). We used the dominating nine-item scale developed by Covin and Slevin (1986, 1989). A factor analysis revealed that two items did not load on the EO factor and were dropped. The remaining seven items were summed to an index with a Cronbach's Alpha of 0.73. We also included two control variables related to the governance of the firm. These were *Board Size* measured as the number of directors on the board (excluding possible employee representatives) and *Number of Board Meetings*, measured on an annual basis. Based on ISIC codes, we also constructed nine industry categories and included dummy variables for eight of those.

4. Analysis and results

The correlations and descriptive statistics for the non-categorical variables are presented in Table I. None of the correlations are notably high. The hypotheses were tested using hierarchical regression analysis. The results are displayed in Table II. The control variables of industry, firm age, firm size and EO were first included in a base model. The results are reported in column two of the table. This model explains about 10% of the variance ($p < 0.001$). A strong positive effect can be noted for EO, suggesting that firms with a more entrepreneurial orientation are more likely to become involved in strategic change activities. A positive effect is also found for firm size, suggesting that larger firms are more prone for strategic change. No effects are noted for the industry control variables or age. In the next step, we add the governance control variables. The results are reported in column three of the table. This model makes a significant contribution over and above the base model ($\Delta R^2 = 0.02$, $p < 0.001$). As could be anticipated, a larger and more active board (in terms of the number of board meetings) is associated with more strategic change. We then entered the independent (main) effects in the third step, corresponding to the tests of H1, H2 and H3. The results are reported in column four of the table. The main effects model makes a significant contribution over and above the base model ($\Delta R^2 = 0.03$, $p < 0.001$). Within the main effects model, examining the regression coefficients, the findings suggest that a larger TMT is associated with more strategic change, supporting H3 ($p < 0.001$). As anticipated by H2, outside directors on the board are associated with more strategic change ($p < 0.01$). Also H1 was supported by the data, with closely held firms exhibiting less strategic change ($p < 0.05$). Thus, H1, H2 and H3 are all supported by our data. Interestingly, as the outside director variable was entered into the equation at this stage, the board size variable loses its significance, suggesting that it is the presence of outside directors rather than the size of the board itself that matters most for strategic change. We did not hypothesize an interaction between ownership and the TMT because the board mediates the relationship between owners and the TMT. However, as a check of the robustness of our findings, we tested for potential interactions between the two but none were found.

TABLE I
Descriptive statistics and correlations for relevant variables

Variables	Mean	S.D.	Intercorrelations				
			1	2	3	4	5
1. Firm age (years)	31.48	27.48					
2. Entrepreneurial orientation	4.21	0.75	−0.108**				
3. TMT size (# individuals)	4.76	1.99	0.012	0.153**			
4. Firm size (FTE)	82.30	225.67	−0.064*	0.065*	0.198**		
5. Board size (# individuals)	4.07	1.73	−0.115**	0.090**	0.232**	0.191**	
6. # Board meetings	3.73	3.65	−0.023	0.068*	0.047	0.040	0.248**

Note: $^{*}p < 0.05$; $^{**}p < 0.01$.

TABLE II
Results of hierarchical regression analysis of the effect of governance on strategic change

Control variables					
Manufacturing	0.02	0.07	0.03	0.03	0.03
Retailing	−0.11	−0.06	−0.08	−0.08	−0.08
Hospitality & trade	−0.04	−0.03	−0.07	−0.07	−0.07
Transportation	0.01	0.03	0.01	0.01	0.00
Financial services	−0.03	−0.04	−0.05	−0.05	−0.05
Real estate	−0.01	0.02	−0.03	−0.03	−0.03
Education	0.05	0.04	0.03	0.03	0.03
Health care	0.03	0.03	0.02	0.02	0.01
Firm size	0.08*	0.06	0.04	0.04	0.04
Firm age	0.05	0.03	0.02	0.02	0.02
Entrepreneurial orientation	0.29***	0.28***	0.25***	0.25***	0.25***
Governance controls					
Board size		0.10**	0.03	0.03	0.03
# Board meetings		0.10**	0.09*	0.09*	0.09*
Main effects					
Closely held (CH)			−0.09**	−0.19**[a]	−0.09**
Outside directors (OD)			0.09**	0.03[a]	0.28**[a]
TMT size			0.13***	0.13***	0.23***[a]
Interactions					
CH × OD				0.13*	
TMT size × OD					-0.24**
Model[a]					
R^2	0.10	0.13	0.16	0.16	0.17
Adj. R^2	0.09	0.11	0.14	0.15	0.15
Change in R^2	0.10***	0.02***	0.03***	0.01*	0.01**

Note: Standardized regression coefficients are displayed in the table.
[a]In the presence of interactions, the coefficients for independent terms making up the interactions convey no meaningful, but possibly misleading information (Cohen and Cohen, 1983).
***$p < 0.001$, **$p < 0.01$, *$p < 0.05$, $n = 847$.

4.1. *Full model including interaction effects*

The hierarchical approach is necessary since an interaction effect exists if, and only if, the interaction term gives a significant contribution over and above the main effects only model (Cohen and Cohen, 1983). The following two columns of the table report the findings when each of the two two-way interaction terms corresponding to H4 and H5 is added into the equation. The addition of the interaction term of ownership (closely held) and board characteristics (outside directors) gives a statistically significant improvement in model fit ($\Delta R^2 = 0.01$, $p < 0.05$). The regression coefficient is positive and statistically significant at $p < 0.05$. The results are reported in column three of the table. Given that the interaction term consists of two dummy variables, it is evident that the presence of outside directors has a particularly strong positive effect in closely held firms, supporting H4.

The addition of the interaction term of board characteristics (outside directors) and TMT characteristics (TMT size) gives an explanatory contribution over and above that of the main effects only model. Explained variance increases by 0.01 and the increase is statistically significant at $p < 0.01$. This suggests that an interaction effect is indeed present. Examining the regression coefficient of the interaction term, it is evident that the size of the TMT moderates the relationship between outside directors and strategic change. Given that outside directors is a dummy variable, and that the regression coefficient of the interaction term is negative, it is

immediately apparent that the effect of TMT size is stronger in firms that have no outside directors. Thus H5 is supported by our data.

5. Discussion

Previous governance research has not paid sufficient attention to the interaction effects of different governance mechanisms (Rediker and Seth, 1995). We argue that it is particularly important to examine such potential interactions in SMEs. Many SMEs are closely held with potential change aversion. However, we believe that such possible negative ownership consequences can be counteracted by the active use of other governance mechanisms. Previous studies typically focus on one type of governance mechanism, most commonly held the board, to the exclusion of others. In this paper we have addressed this gap in the literature and examined how ownership, outside directors and TMTs interact to promote strategic change in SMEs.

The general logic of our argument is supported by our findings. Firms' willingness to change strategically is affected by their governance. As we hypothesized, closely held firms exhibit less strategic change than other SMEs (H1). This finding is in line with previous observations of general risk aversion of owner-managers leading to reluctance to change (Beatty and Zajac, 1994; Denis et al., 1997) and a general conservativeness in many closely held firms (Aronoff and Ward, 1997; Kets de Vries, 1993; Sharma et al., 1997). But strategic inertia in SMEs has also reasons other than unwillingness to change. Strategy-making is a challenging task, requiring the capacity to interpret a complex environment and the competence to mobilize and manage the resources necessary to respond to the competitive challenges that have been identified.

Particularly in SMEs where strategic leadership often lies in the hands of a single person, there can be a lack of resources and skills to bring about change. On this point and in line with our hypotheses 2 and 3, the results indicate that it is possible to facilitate strategic change by introducing governance mechanisms that increase the strategic capacity and competence of the firm. This means that the presence of outside directors on the board (H2), as well as increasing the size of the TMT with members others than the CEO (H3) makes strategic change more likely to happen. With reliance on outside directors or additional top managers in decision-making, strategic leadership is no longer limited to a single individual. The additional strategists can contribute to change by increasing cognitive diversity (Amason, 1996; Amason and Sapienza, 1997; Forbes and Milliken, 1999), linking the company to important external stakeholders (Borch and Huse, 1993; Huse, 2000; Zahra and Pearce, 1989) and increasing the legitimacy of the organization (Johannisson and Huse, 2000; Pfeffer and Salancik, 1978).

In many SMEs, the owners, board and the top management overlap. This means that it is relevant to look closer into interaction effects among different governance mechanisms. In order to investigate this, we first hypothesized that outside directors would be particularly important to – and therefore have a stronger positive effect on – strategic change among closely held firms (H4). This interaction was supported, which suggests that the benefits of outside directors and the value they add in terms of cognitive diversity, relationships with important external stakeholders and legitimacy is particularly important to closely held firms.

Second, we hypothesized and found that the positive effect of outside directors was moderated by the size of the TMT. It appears that a larger number of individuals involved in the management and decision-making of the firm, as indicated by a larger TMT, can compensate, in part, for the absence of outside directors. An interpretation of this finding is that the enhancement of the firm's capacity and competence for change can be achieved in different and complementary ways. The question of how this enhancement is achieved – via the board or via the TMT – is of secondary importance. It suggests that SME managers have leeway in choosing between the two, that is, there is the option of either increasing the size of the TMT or taking on outsiders on the board when seeking to achieve strategic change. This is an important finding that adds to our previous understanding of the interaction between the

board and top management in SMEs. The finding suggests that by introducing a larger TMT or by electing outside board members, SMEs can create more favorable conditions for strategic change.

6. Conclusions, implications and limitations

Our findings suggest that the roles of the board and the TMT may not be separate and clear cut, which points to the benefits of researchers conjointly assessing different governance mechanisms in SMEs. This finding is particularly interesting to SME owner-managers and to those providing advice to these firms. Irrespectively of whether adverse environmental conditions or emerging new opportunities call for strategic change, such change is often difficult for SME managers to accomplish. Our advice is clear cut. Expanding the circle of individuals involved in decision-making helps overcome these problems, and this is particularly relevant if the SME is closely held. One route can be to take on outside directors on the board.

The other option is to extend the TMT by adding additional members. Either of these options appears viable. Given that many SME owner-managers are reluctant to appoint outside directors, as this implies a perceived loss of control and giving non-owners a powerful position in the firm (Ford, 1988; Gersick et al., 1997; Ward, 1991), adding members to the TMT could be a more attractive option for many. It facilitates change while keeping the board with its legal and formal rights and responsibilities purely in the hands of the owners. We note that several organizations provide advice to SME managers and that outside directors is a common recommendation. While we agree with this recommendation, similar outcomes can be obtained by an extensive and well functioning TMT. To many SME owner-managers, actions to improve on top management may be a more attractive solution.

The dynamics that different governance mechanisms, such as outside directors and TMTs, add to strategy-making in small firms opens up interesting avenues for future research. Studies on the influence of corporate governance on strategic change can enhance our knowledge on the conditions for change in general and lead to important implications for managerial practice. Especially, studies on TMTs in SMEs are still scarce (Ensley and Pearson, 2005; Gibbons and O'Connor, 2005). While our present study makes a contribution in this direction, it also raises questions for further investigation. For example, it would be interesting to examine the degree of independence and specific expertise held by the outside directors on the board. One might suspect that outside directors often have close relations to the SME manager and owner based on friendship or professional ties. This may result in lack of real power and potential to contribute more extensively to the firm's strategy. Similarly, more fine-grained aspects of the TMT likely affect to what extent and in what way TMTs contribute to strategic change activities. For instance, Ucbasaran et al. (2003) address functional heterogeneity and experience of the TMT members as relevant variables which influence important outcomes, such as exits from the TMT. Unfortunately, our data do not allow us to make such fine-grained assessments.

Our study is not without limitations. We opted for a broad sample containing SMEs of varying size, industry, and governance. This increases the generality of our findings, facilitating inference to a wide population. On the other hand, there is a trade-off because it also increases heterogeneity relative to a more limited and uniform sample. As a result of this largely unobserved heterogeneity, model fit is limited as indicated by relatively low explained variance in our regression models. Hence, results should be interpreted with some caution. Still, we need to keep in mind that strategic change is a complex phenomenon and that governance mechanisms only represent a limited part of the variables affecting strategic change in a firm. Given these circumstances, the fact that we have been able to show effects of governance on strategic change in line with the predictions of theory constitutes a contribution.

The data for this study has been collected in Sweden. Although the hypotheses tested and supported by our data are based on general theories and findings from a range of countries, country-specific effects cannot be ruled out. As argued above, the Swedish governance system

shares features of the Anglo-American as well as the German systems, but is not identical to either. Therefore, care must be taken in generalizing our findings to other institutional contexts. Moreover, our empirical results show that strategic change occurs relatively frequently also in the firms in our sample that are not closely held. Many of these firms are subsidiaries. Unfortunately, we are not able to provide a more detailed analysis of the extent to which the subsidiaries themselves drive strategic change or carry out decisions of the parent company. We encourage future research to look deeper into this issue.

In conclusion, this paper shows how governance mechanisms affect the ability of SMEs to introduce strategic change. Building on agency theory and insights from the literature on SME governance we hypothesized that governance variables related to ownership, the board of directors and the top management team all affect strategic change, and that it is important to examine the interaction effects of these governance mechanisms. This general logic is supported by our analyses, indicating that both theory and management practice can benefit from viewing governance mechanisms conjointly rather than considering them one by one. This is particularly important as the choice of governance mechanisms actually does affect firms' ability to change their strategy.

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