Effective governance for start-up companies: regarding the board as a strategic resource

Coral B. Ingley*

Faculty of Business
AUT University
Private Bag 92006, Auckland 1020, New Zealand
E-mail: cingley@aut.ac.nz
*Corresponding author

Kevin McCaffrey

Effective Governance
42 Cliff Road
Torbay, Auckland 0630, New Zealand
E-mail: Kevin@effectivegovernance.co.nz

Abstract: Start-up organisations are small companies that experience a high level of growth and considerable risk to their very survival until they evolve into stable, established companies. This situation presents a particular set of challenges in terms of corporate governance, yet research on the governance of start-ups is limited.

This research paper examines and comments on the governance of start-up organisations in New Zealand. The study replicates and extends previous New Zealand-based research of boards of established companies.

From the data gathered from the two surveys, conclusions can be drawn as to the role and focus of boards in start-ups versus established companies. The results are consistent with a model of active ownership which identifies key differences from established companies that could improve the governance of start-ups. The results also highlight the dependence of what might constitute effective corporate governance for a start-up on the strategic context of the company and its life cycle stage.

Keywords: governance model; established companies; start-ups; active ownership; strategy; moral context; corporate entrepreneurship; Icarus Paradox.

Reference to this paper should be made as follows: Ingley, C.B. and McCaffrey, K. (2007) 'Effective governance for start-up companies: regarding the board as a strategic resource', *Int. J. Business Governance and Ethics*, Vol. 3, No. 3, pp.308–329.

Biographical notes: Associate Professor Coral B. Ingley lectures on corporate governance and strategic management in the MBA programme at the AUT University in Auckland and in Bangalore, India. She is a Director of several companies in New Zealand and a Corporate Mentor to CEOs, advising on strategy, start-ups and business development.

Kevin McCaffrey (BsocSc, M. Mgt) is the Managing Director and founder of Effective Governance New Zealand. Formerly a Partner in the Asia Pacific consultancy practice of PricewaterhouseCoopers, he specialises in

Copyright © 2007 Inderscience Enterprises Ltd.

strategy development, governance reviews and change management. He has led client engagements in public and private sector organisations across the Asia Pacific region.

1 Introduction

There is little research available that addresses the governance of start-up organisations (hereafter also referred to as start-ups) and how effective governance in this type of company can contribute to better organisational performance (Mair, 2000; Fox, 1995). The formation and structure of the board can impact on corporate governance and company performance (Bohren and Odegaard, 2003).

For established companies recent changes in the structuring of boards have largely been driven by regulatory reviews. These changes have focused on the separation of chairperson's and CEO's roles and the appointment of a minimum number of independent directors. For start-up organisations the formation and structure of the board is usually related to the need to attract capital, skilled resources and their networks rather than regulatory demands (Tan, 2001; Mair, 2000).

A study by Ingley and van der Walt (2005) of strategic governance in established companies in New Zealand provided a useful framework to identify what comprised effective governance and how this was linked to organisational performance. The study reported in this paper replicated and modified their theoretical framework and made selective use of their questionnaire and database, targeting New Zealand start-ups to examine and comment on their governance practices. The survey conducted for this study focused on:

- the board's role in strategy
- the board's level of influence and control
- board composition.

The aim was to identify any significant differences in the governance models for established companies versus start-ups. From this comparison conclusions could be drawn as to what comprises effective governance for start-ups in New Zealand and how it may be linked to organisational performance.

2 Review of the literature

In general there is no clear empirical support for effective governance delivering enhanced corporate performance. However, there is sufficient anecdotal comment and a growing body of empirical evidence to conclude that the concept is supportable and can provide direction for improved governance with an expectation of enhanced organisational performance. For example, Strenger (2004) confirmed in recent research that companies with demanding standards of governance achieved higher market values. However, there is no model for corporate governance that applies to all organisations. Governance frameworks are likely to vary across cultures, economies, legal systems and context as well as organisational size and nature.

Key theoretical underpinnings for corporate governance include agency theory, stewardship theory and resource dependency theory. These theories inform the role of the board in value creation and provide a basis for current models of corporate governance.

2.1 Agency theory

According to Berle and Means (1932), agency theory focuses on the fundamental separation of ownership and managerial control. The advent of managerial corporations gave rise to managers with knowledge and expertise superior to that of the owners/shareholders (Becht *et al.*, 2002). Agency theory holds that a conflict of interest arises wherein managers are rewarded for self-interested action to the detriment of shareholders. This view presupposes that managers will, for example, encourage growth and expansion in order to reduce their own employment risk and maximise their personal rewards at the expense of shareholders who seek profit maximisation over the longer term and an increase in capital value. For corporate governance the implication is that adequate monitoring systems need to be established to protect shareholders from managers' exploitation of their self-interest (Ingley, 2004).

Agency theory raises two key issues regarding corporate governance and organisation performance:

1 the influence of board composition on organisation performance

2 the impact of corporate leadership structures.

These issues highlight current concerns such as the independence of directors and diversity in board composition, as well as separation of the chair and CEO roles (Ingley, 2004). Becht *et al.* (2002) argue that, with the rise of large complex entities, corporate governance must identify how best to resolve the collective actions of dispersed investors and provide adequate monitoring and balance. Whilst these concerns may be relevant in large organisations, they may not be so in start-ups. Van den Berghe and Levrau (2004) studied agency relations within small business systems to identify optimal contract conditions. However, they found that there was insufficient information available to identify the optimal 'agency' contract in a small shareholding company.

2.2 Stewardship theory

In contrast to agency theory, stewardship theory argues that managers are stewards of the resources entrusted to them and can be trusted to maximise profits for shareholders. This means that demands for extensive monitoring and controls are not necessary as executive directors understand the business and external directors cannot match their level of knowledge and expertise. Stewardship theory holds that external directors do not have the skills, knowledge, time or resources to effectively monitor management (Ingley, 2004).

This debate between the role of internal and external directors is at the heart of stewardship theory. The Anglo model of governance focuses on the shareholder as the ultimate arbiter and promotes this influence via external directors. However, the German-Japanese models of governance heavily favour internal (or executive) directors. Thus there are cultural elements in the debate as well as contextual aspects (Becht *et al.*, 2002).

Keil and Nicholson (2003) found that, after controlling for company size, board size was positively correlated with firm value. Most importantly, they found that a positive correlation existed between internal directors and market-based performance. This is in contrast to recommendations by Higgs (2003) that a minimum number of external directors should be appointed for effective governance.

The debate over the relative advantages of internal and external directors introduces the issue of board diversity. Among many recent studies, Carter *et al.* (2003) showed a clear link between board diversity and firm value. After controlling for size, industry and other corporate governance measures they found a positive relationship between the proportion of women and minorities on boards and firm value. This finding argues against the stewardship perspective that favours internal directors (as found by Keil and Nicholson, 2003) where homogeneity in board membership is preferable to the inclusion of external directors.

Dawson (2004) argued that adherence to governance structures and procedures as prescribed in corporate governance codes of practice is insufficient for effectiveness and limits governance to forms and procedures that restrain the organisation from achieving its potential. He contended that consideration needs to be given to releasing the entrepreneurial self-interest of management within a 'moral context' – defined as an agreed set of values, behaviours and norms to guide management decisions. By encouraging an agile and entrepreneurial approach, this concept potentially has relevance for start-up organisations which lack formal and codified governance procedures. Start-ups have to build management and governance procedures as they develop and they need a framework to guide decision making.

2.3 Resource dependence theory

Resource dependence theory argues that the board is an essential link between the organisation and the key resources it needs to maximise performance. From this perspective the board is seen as an important resource for the business, particularly for their external links which may include providing access to capital, customers, suppliers and other influential agencies. This is based on the directors' professional capabilities, commercial awareness and technical skills and their own networks and linkages that represent a pool of social capital for the business (Ingley, 2004). Importantly the directors provide access to their social networks which brings a reciprocal flow of information, services and cooperation.

When considering the model for effective governance for start-ups it is apparent that using the board as a value-adding resource can be a key factor in helping the organisation to achieve its objectives.

3 The board's role and structure

The negative aspects of corporate collapses and scandals such as Enron and Tyco have given rise to reactive recommendations such as those found in the Higgs Report which advocated that in the UK:

- There be appointed a senior independent director and at least three directors who are independent of the management and current board.

- The roles of chairperson and CEO be held by different persons.
- A former CEO of a company does not become the chairperson of that company's board (Higgs, 2003).

Particular emphasis is given in the Higgs Report to the independence of committee membership on boards, especially audit committees. The link between effective governance and organisation performance is at best tenuous but, when single elements are examined separately, positive relationships can be shown (Bohren and Odegaard, 2003). Beekes *et al.* (2004), for example, examined the links between the presence of external directors on boards of UK companies and corporate performance, using the following factors:

- financial reporting
- quality earnings
- timeliness of reporting
- conservatism of forecasts
- board composition.

They found that firms with a higher proportion of outside directors were more likely to recognise bad news on earnings earlier than firms with few or no outside directors. Moreover, boards with a relatively higher proportion of external directors displayed less conservatism with regard to releasing good news. This suggests that board composition is a factor in determining the quality of firms' reporting of earnings and thus, in that way, is a predictor of corporate financial performance.

Contrary to the Higgs recommendations Wier *et al.* (2003) showed from a UK study of non-executive directors and board committees that neither the independence of, nor the quality of, committee members had any impact on organisational performance. While independence of audit committee membership would seem desirable from an accountability perspective, there is conflicting evidence regarding the belief that measures such as those recommended in the Higgs Report will have a positive effect on company performance.

Similarly, research concerning North American board effectiveness conducted by Weisbach (cited in Denis and McConnell, 2003) showed that:

- Higher proportions of outside directors did not lead to improved corporate performance but were associated with better decisions regarding mergers and acquisitions, executive compensation and CEO appointments.
- Board size was negatively correlated to corporate performance and the quality of decision making.
- Changes in board composition were negatively related to corporate performance, CEO turnover and changes in ownership structure.

In most European countries the role of the board is not prescribed in law; however, the European Union is seeking to introduce a common Code of Conduct for boards to follow. Wymeersch (1998) notes the attitudes of some major shareholders who oppose such a code on the basis that independent directors will reduce shareholders' level of influence.

A similar situation exists in Japan where companies generally have significant borrowings from banks and concentrated shareholdings who seek representation on their boards. Kaplan and Minton (1994) showed that in Japan the appointment of outside directors can be effective in stabilising and modestly improving corporate performance.

The evolving thinking in the literature concerning the link between governance structures and performance has largely arisen as a result of shareholder activism in the 1980s and 1990s. With the increased wealth of baby boomers in advanced western economies more investment has flowed into the capital markets and broadened the base of shareholders. This dispersed shareholding has given a freer hand to boards without the scrutiny of shareholders acting as shareowners (Monks and Minow, 2003). The rise of specialty equity management funds and, in particular, pension-fund managers, has seen shareholder activism become a force in the capital markets. These large pension-fund investors have the resources, skills and time to be active and influential in putting pressure on boards of listed companies to improve their governance (Monks and Minow, 2003). Whilst the evidence is inconclusive regarding the influence of independent directors on organisational performance, shareholder activists have led the debate with regard to governance reforms that favour the appointment of non-executive (*i.e.*, independent) directors to boards (*e.g.*, Higgs, 2003).

Though some evidence indicates that independent directors may have little impact on organisational performance, the relationship between director experience and effectiveness is of interest. Westphal (2002) stated that the most important predictor of director effectiveness is not independence but strategic experience that matches the company's needs. This is an important factor to consider in start-ups as they rely on the directors as a resource pool in the absence of a mature management structure with the appropriate level of resources.

4 The board's influence and control

For established companies the board's role and influence are clearly defined in the corporate governance literature and there is delineation between directors' and management's responsibilities. For start-ups these roles are not always so clearly defined. In a start-up board members are often significant shareholders or are a key management resource because of their particular expertise.

Carter and Lorsch (2004) argued that the distinction between governance and management cannot always be clearly defined in a way that draws a straight line, particularly in an age of increasing complexity and change in companies. In start-up companies boards are smaller with a concentration of ownership. As a result some of the management roles may be undertaken by board members who are involved in management and operational decision making. This is because start-up companies often lack a range of corporate service skills such as finance, human resources, information technology and legal expertise. As a result, they may look to the board to provide these skills (Daily and Dalton, 1993; Smith, 2003). Accordingly, directors in start-ups firms have greater reach into the company's operations and decision making, directly rather than through monitoring and reporting, as is the case in large companies. This means that in smaller companies directors may have greater influence on company performance through greater involvement in decision making (Dawson, 2004).

This raises the issue of independence of directors in small companies and start-ups where directors are mainly insiders and may be specialists but lacking business expertise. The criticism is that start-ups lack adequate governance procedures when compared with established governance standards. Dot.com companies were the particular target of such criticism and governance inadequacy was considered to be a significant factor in their failure (Ingley, 2004; Kwak, 2002; Larson, 2000). However, Larson (2000) argues that newly emerging business models such as high-tech start-ups require different governance procedures and that established companies can learn agility and flexibility from the start-ups.

5 Governance of start-ups

The governance of start-ups needs to be considered according to the particular context within which they operate. Their activities are focused predominantly on achieving critical milestones that provide rapid and substantial growth (Bell and Mason, 1995). Case (2001) defined such growth as compounding annual growth of 20% for a period of at least four years. According to Case, the nature of their innovation and the potential of their underlying productivity gains is also a feature of start-ups that delivers success in the market.

Start-ups tend to focus on smaller, uncertain opportunities with large growth potential. The demand for capital drives a series of decisions and events that pose significant risks for the organisation and places unique demands on the board (Bhide, 2000; Smith, 2003). As a result, the governance of start-ups can be expected to evolve in forms that reflect their needs and in a context which differs from that of established boards.

The board of a start-up is small and typically comprises the inventor, major shareholder and a few other investors which will result in a concentration of ownership and a high level of shareholders'/owners' participation. Directors are more likely to be closely involved in the development and implementation of the strategic plan. They will also have a direct impact on critical decision making which may include aspects of day-to-day management (Forbes and Milliken, 1999).

The role of the directors in this context focuses on guiding and leading the organisation towards the achievement of critical milestones such as those that were identified by Bell and Mason (1995) and were included in their model of a start-up's life cycle. These milestones were:

- concept development
- prototyping and testing
- product manufacturing
- marketing and distribution.

For start-ups the board is seen as a resource pool and a think-tank with specialist skills that are directly applied to the business issues at hand, with less emphasis on compliance and a concern for mitigation of current risks, particularly that of failure (Daily and Dalton, 1993). Daily and Dalton (1993) noted that a goal of many entrepreneurs is to create a large multinational organisation, whilst others might aim to sell down, float as a public offering, or exit in a trade sale to realise the value of their investment.

The governance of start-ups reflects the emerging needs of the organisation at a crucial stage of its development. Ingley and van der Walt (2003) argued that whereas no universal model exists for corporate governance, as organisations evolve through their life cycle they have differing governance requirements. For this reason, the board should be structured to reflect competencies required by company's strategic circumstances (Ingley and van der Walt, 2003).

The challenge of governance in start-ups is to balance the demands for effective governance with the challenges of high growth (Bhide, 2000). Taylor (2003) argued that with effective board leadership this balance is achievable if the board avoids a focus only on the owners' entrepreneurship, which can lead to a single director having too great an influence. He advocated developing an entrepreneurial board with accountability and controls that foster 'corporate entrepreneurship'. In order to move from an emphasis on corporate governance that concentrates on monitoring and control to encouraging corporate entrepreneurship, a critical ingredient is 'active ownership' where the owners actively drive the strategy and have a significant influence on its implementation.

A key aspect of the literature is the idea that to be successful, small companies need to attract the right mix of capabilities, business expertise and experience onto their boards. Deakins *et al.* (2000a; 2000b) conducted a study of 23 small entrepreneurial companies with matched data for CEOs, executive- and non-executive directors. Consistent with the resource-dependency view of the firm, they found that the role of external directors brings contacts, disciplines and planning skills. In start-ups this role is often filled by a strategic investor such as a Venture Capitalist (VC).

Research shows that VCs purposefully use the board to manage a portfolio of investments to maximise the return on their investment. Boards with VCs present tend to be more active than other boards particularly in the areas of strategy and critical decision making (Gabrielson and Huse, 2002).

The consequences of involving VCs on start-ups boards were examined by Lorsch *et al.* (2001) who found that when high-tech start-ups go public the board is dominated by company executives and VC directors. They contended that this is deeply flawed and puts the company at risk. Such a board lacks independence, which leads to conflicts of interest with shareholders. They also noted a vested interest for VCs to sell out early and take super profits at the expense of shareholders.

Lorsch *et al*. (2001) found that many VCs disposed of one third of their equity in the first two to six months after the lock-up period, some by as much as 80%. Whilst this may be their stated intention when investing, the ramifications for ongoing investors and company performance can be significant. The departure of VCs changes the balance of the board and requires the introduction of new directors who may have different skill mixes and other investment goals.

The skills the VC brings to the board are recognised as a positive contribution by Kwak (2002) who examined 91 US companies where the company had the founder present as CEO. Kwak then compared these with a matched sample of companies from the same industry not run by the founder. He discovered that founder-run companies tended to have fewer independent directors and a concentration of ownership, with the CEO exercising significant control over the board. This situation can lead to the 'Icarus Paradox' where the founder-CEO is over-confident of his or her abilities, leading to a sense of invincibility which may foster reckless actions. For such CEOs, their early success can breed complacency, inertia and risk-aversion. Kwak (2002) argued

that far-sighted CEO-entrepreneurs create a strong board with their own sources of information and analysis so that the board members can serve as an effective counterpoint to the CEO.

The challenges faced by entrepreneurial start-ups thus provide a special context and may differ greatly from those experienced by established firms (Keil and Nicholson, 2003). Start-ups face the challenges of the high cost of capital, scarcity of managerial skills and intense competition. Ironically, large companies may be more agile and able to change direction whereas start-ups may be locked into a single investor's direction (Kwak, 2002; Nesheim, 2000). In a useful and widely-published handbook for launching high-tech start-ups, Nesheim (2000) noted that because of these challenges 60% are likely to fail.

The purpose of this study is to extend Ingley and van der Walt's (2005) research on established companies by comparing these to small start-up companies in a New Zealand context, in order to distinguish between their differing governance features. The concept developed for this study proposes that start-ups evolve to meet the needs of their situation and context, based on Bell and Mason's (1995) performance focus and Taylor's (2003) description of 'active ownership'. The elements of active ownership imply that a board in a start-up company will have a more direct influence on organisational performance through engaging in key activities, such as capital raising, research and development, and product manufacturing, as well as marketing and distribution decisions (Bell and Mason, 1995). This reasoning is encapsulated in the following input-output model of active ownership, comprising three main categories: 'fit for purpose', 'board' and 'organisational performance', described below.

5.1 Fit for purpose

This category describes the purpose of the board and selection criteria for its composition. As indicated by Keil and Nicholson (2003) the board is selected for the purpose of guiding and steering the organisation. In addition to its small size and concentration of ownership, the board of a start-up is characterised by the selection of directors for the key skills and experience they bring to the organisation.

5.2 Board

The board of a start-up may comprise a mix of internal and external directors and may include a representative from a significant shareholder or a strategic investor such as a VC (Lorsch *et al.*, 2001). The model indicates that the start-up board will have a high level of engagement in areas of strategy development and implementation, critical decisions, key operational decisions and board composition.

5.3 Organisational performance

While there is no conclusive evidence to link the performance of the organisation and effective governance, much of the research points to positive relationships between certain features or elements. For instance Bohren and Odegaard (2003) found that there was a positive relationship between the level of internal ownership and economic performance. They also showed that board size had an impact on the effectiveness of governance and subsequently on corporate performance. Ingley (2004) summarised

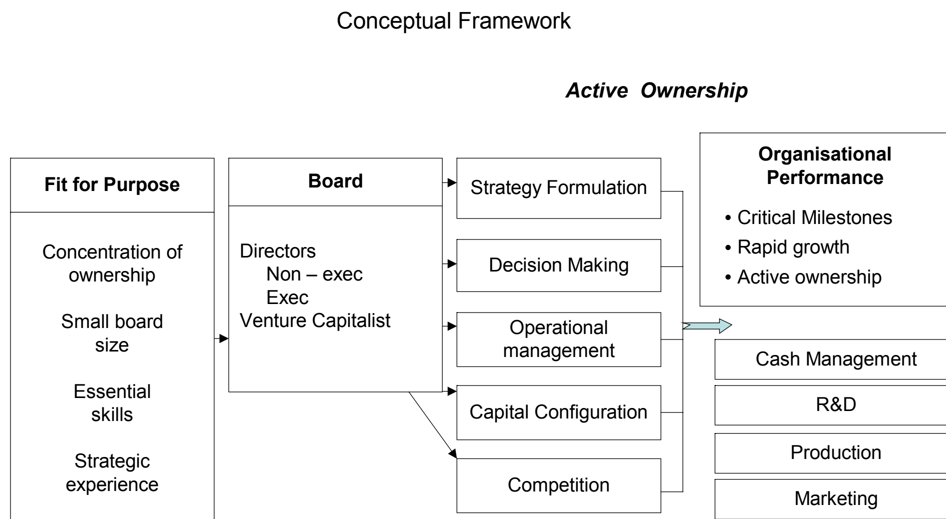
a considerable body of empirical literature that supported a link between elements of governance and various financial and market-based measures of organisational performance in established companies. Using a range of financial and non-financial indicators of growth and competitiveness, Ingley's (2004) research of established organisations also provided support for such a link. Key indicators of organisational performance for a start-up will include the achievement of critical milestones, a focus on rapid growth and a high level of engagement by the directors as active owners of a start-up company (Bell and Mason, 1995).

5.4 Active ownership

Active ownership is the description given by Taylor (2003) of boards of small start-up companies where owners and directors are actively engaged in the development and implementation of strategy in the business. Bell and Mason (1995) described the various activities that are critical to the successful evolution of start-ups. It is notable that this involves decision making that would generally be the exclusive domain of management in an established company. Of prime importance are the directors' requirements to attract capital and manage capital deployment. Bell and Mason (1995) also described the key functions of a start-up which follow its life cycle from R&D through production to marketing. Overlaying these functions is the key activity of cash management, which is the lifeblood of a start-up.

The conceptual framework in Figure 1 depicts the board of a start-up as being actively engaged in key aspects of guiding the business through its critical development phases. This results in directors being selected for their skills in the business, their access to valuable networks and their ability to contribute (primarily financial, but also intellectual and social) capital. This level of involvement highlights the situational nature of corporate governance relative to the company's stage in its life cycle.

Figure 1 Active ownership model for start-up boards



Source: McCaffrey (2005)

6 Research method

In their study Ingley and van der Walt (2005) examined board effectiveness in a comprehensive survey of New Zealand directors. Their questionnaire and resulting data form the basis of this study. A selected set of questions from their questionnaire was extracted to extend the survey to a targeted sample of 180 start-ups. This data was then compared to Ingley and van der Walt's (2005) data for directors of 420 established companies.

In order to identify a defined population for start-ups, meetings were held with the leaders of organisations who work with start-ups to conduct research and provide establishment and development support. These included the Massey University *e*-Centre technology incubator centre, The University of Auckland Ice House technology centre, Hi Growth NZ, the New Zealand Government and personal contacts in capital investment organisations. Confidentiality protocols prevented these organisations from providing mailing lists to a third party, so copies of the survey and self-addressed, reply-paid envelopes were given to each organisation, which they then distributed to their members. Completed questionnaires were returned anonymously and individual directors could not be identified. Of 180 questionnaires distributed, 74 valid replies were received yielding a 41% response rate.

To allow comparisons to be made between the established organisations researched by Ingley and van der Walt (2005) and start-up companies, a set of specific questions relating to three areas of focus was drawn from their survey. The questions examined:

- the board's role in strategy (the focus of discussion in board meetings, the board's role and involvement in developing strategy and the relative importance of various board tasks)
- the board's level of influence and control (the extent of the board's influence and control over various internal and external factors that impact on company performance)
- board composition (factors influencing the selection of non-executive board members).

Data was first analysed to examine patterns within the start-up sample. This involved summing the frequency of responses by type of response and allocating each a percentage. Missing data was then extracted and the percentage was recalculated as a 'valid percent'. This data was used for comparative purposes with the original Ingley and van der Walt (2005) survey, using the valid percentage from both sets of data.

7 Results and discussion

7.1 Characteristics of established companies and start-ups

The following characteristics of the start-ups in the study were compared with those of established companies in the original sample:

- position as a director on the board
- level of equity holding in the company
- annual revenue.

Table 1 Position as a director on the board

Type of director	*% start-up*	*% established*
Non-executive director	14.5	50.3
Executive director	26.1	9.8
Chairperson	14.5	25.9
CEO and board member	44.9	14.0
Total	100.0	100.0

In the start-up data it is notable that the directors are predominantly executive directors (26%) and CEOs (45%). This means that over 70% of the sample is engaged in running the business as well as being on the board.

In the original survey half of the sample were non-executive directors and were not involved in running the company. Only 10% were executive directors.

Table 2 Proportion of equity held

Equity holding	*% start-up*	*% established*
Nil	18.8	63.8
1% to 10%	27.5	21.5
11% to 20%	7.2	4.1
21% to 30%	11.6	3.3
More than 30%	34.8	7.2
Total	100.0	100.0

In established companies up to 64% of the directors held no equity in the company compared with only 19% in start-ups.

By contrast, in start-ups 35% of the sample can be classed as a major shareholder in the company, *i.e.*, with greater than 30% ownership.

Table 3 Annual turnover in the last financial year

Turnover	*% start-up*	*% established*
Up to $500,000	23.2	3.7
$500,000 to $1 million	17.4	4.9
$1 million to $5 million	32.0	18.4
$5 million to $10 million	8.7	10.8
$10 million to $30 million	5.8	18.4
$30 million to $50 million	1.4	12.3
$50 million to $100 million	4.3	10.6
More than $100 million	7.2	20.9
Total	100.0	100.0

It is notable that 72% of the start-up sample has a turnover of less that $5 million. By contrast 73% of the original sample of established companies had a turnover greater than $5 million. As expected, start-ups are very small companies, a large proportion of which have a turnover of $1 million or less whereas established companies are much larger in size with a similar proportion having a turnover at least 30 times greater than the start-ups.

When industry sector is taken into account, the data indicated a similar distribution of industry representation and thus comparability between the samples. Start-up companies were, unsurprisingly, more highly-represented in the technology sector than established organisations, which had a greater representation in the primary sector than start-ups.

8 The board's role in strategy

The board's role in strategy was examined in the context of three areas to ascertain the relative emphasis placed on strategic versus operational matters. The three areas comprising this evaluation of the board's role in strategy were (a) the focus of discussion in board meetings, (b) the board's role and involvement in developing strategy, and (c) the relative importance attached to various board tasks.

8.1 The focus of discussion in board meetings

The orientation of the board can be indicated from the relative attention given to the types of topics discussed board meetings. The following table compares the emphasis given to a selection of topic areas by start-up companies and established organisations. This comparison is based on a summary of the data which measured each item on a 3-point scale where 1 = 'often' and 3 = 'rarely'. Table 4 displays these comparisons according to whether the data for each organisation type recorded a larger, smaller or similar percentage of responses than the other type of organisation, for each topic item.

Table 4 Topics discussed in board meetings

Discussion topic	*Start-up*	*Established*
Compliance	less	more
Future development	more	less
Competitive positioning	more	less
CEO leadership	less	more
Routine board matters	less	more
Operational or management issues	more	less
Risk management	less	more

Established companies reportedly focus more on compliance, CEO leadership, routine board matters and risk management. Start-ups, however, focus more on future development, competitive positioning, and operational issues.

From Table 4 it is apparent that the boards of start-ups have a different orientation compared with the directors of established companies. For established companies this is a consistent mix of compliance and governance issues, while their management team looks

after operational matters. In contrast, for start-ups there is an interesting mix of involvement in both strategic issues, such as future development and competitive positioning, and operational aspects. This can be a reflection of the different stage in the life cycle for each organisation type. Start-ups are trying to balance strategy implementation and operational management with limited resources. An established company is focused more on regulation, reporting and compliance.

8.2 The board's role and involvement in developing strategy

Directors in the two sample sets were asked how they each saw their board's role in strategy and what their level of involvement was in the strategy formulation process itself. Tables 5 and 6 compare the two types of organisation based on the percentage of responses for each data set.

Table 5 Board's *main* role in strategy

Role in strategy	*% start-up*	*% established*
Define strategic framework	23.9	34.6
Guide	20.9	5.3
Help formulate	11.9	27.9
Discuss	11.9	3.3
Approve	10.4	7.3
Review	7.5	6.3
Ratify	4.5	4.7
Decision making	4.5	6.6
Risk management	3.0	0.7
Monitor	1.5	3.3
Total	100.0	100.0

Table 6 Board's involvement in developing corporate strategy

Involvement in strategy	*% start-up*	*% established*
Management and the board share strategy development	67.6	65.8
Management develops strategy and obtains board approval	22.1	20.9
Management alone develops strategy	1.5	1.0
Strategy is mostly developed by the board	5.9	11.3
The board alone develops strategy	2.9	1.0
Total	100.0	100.0

Four areas of difference are noteworthy from this data. Regarding their board's main role in strategy, established companies gave higher responses to defining the strategic framework and helping formulate strategy. By comparison start-up companies tended to view their main role as discussing and guiding strategy.

Established companies thus appear to be more concerned with setting the strategic framework and then assisting management with strategy formulation. Start-ups appear to be more concerned with the content of the strategy and being active in the strategy formulation process.

This table shows no major difference between established companies and start-ups when it comes to the strategy development process. Both follow a similar procedure – that of either the management preparing the strategy for board approval, or the development being shared by both management and board.

Considering the role and involvement of the two types of board in strategy, differences in orientation are thus evident. When compared with boards of start-ups, boards of established companies appear to focus more on the process, providing frameworks and being involved in the process whilst maintaining a separation between management and governance. Start-ups follow a similar procedure, but appear to be more focused on the outcome and are concerned about the content of the strategy rather than just the process, with directors taking a more hands-on role. This is consistent with the directors of a start-up being generally shareholders and involved in key decisions made by the business. As indicated in the literature, ownership of start-ups is more concentrated and shareholders are often closely involved in the business (Bhide, 2000).

8.3 The relative importance of various board tasks

The strategic orientation of the board can also be indicated by the emphasis given to strategic versus operational matters with regard to the work of the board. The relative importance the two types of organisations place on various board activities was measured using a 5-point rating scale where 1 = 'very important' and 5 = 'not at all important'. Comparisons between the responses are summarised as follows:

Table 7 Importance of board tasks

Board: importance of tasks	*Start-up*	*Established*
Monitor strategic health of organisation	more	less
Communicate with brokers	less	more
Maintain share price	same	same
Maximise dividends	less	more
Grow shareholder value	same (high)	same (high)
Ensure corporate survival	high	high
Determine risk exposure	less	more
Converse with shareholders	less	more
Converse with stakeholders	less	more
Act as ambassadors	less	more
Responsible for ethical conduct	less	more

Established companies reportedly place greater importance than start-ups on communicating with brokers, shareholders and stakeholders as well as maximising dividends, determining risk exposure, acting as ambassadors for the company and ensuring ethical standards are met. Start-ups place a relatively higher value than established companies on monitoring the strategic health of the business.

Unsurprisingly, both start-ups and established companies hold tasks impacting on organisational performance to be very important, especially growing shareholder value and ensuring corporate survival.

9 The board's level of influence and control

Respondents were asked about the extent of influence they have over various matters relating to their role and responsibility. Items were rated on a 5-point scale where 1 = a 'strong influence' and 5 = 'no influence'. From the summarised data, Table 8 compares the perceived level of influence on company affairs exerted by the boards of start-ups and established companies.

Table 8 Board influence

Level of board influence	*Start-up*	*Established company*
Appointment of CEO	same	same
Appoint new directors	more	less
Compliance with regulations	less	more
Fundamental strategic direction	less	more
Risk exposure	less	more
Organisational profitability	more	less
Shareholder value	more	less
EVA	less	more
Management incentives	less	more
Media perceptions	less	more
Shareholder relations	less	more
Stakeholder relations	less	more
Directors' remuneration	more	less

Established companies reportedly have relatively more influence than start-ups over compliance, strategic direction, risk exposure, economic value added, management incentives, media perceptions, and shareholder and stakeholder relations. This is consistent with the maturity of their organisation.

By comparison, start-ups appear to have relatively greater influence than established companies over the appointment and remuneration of directors, company profitability and shareholder value, which reflects the types of issues they face during development. This may reflect start-up directors' direct involvement in decision making which impacts on both factors.

The data showed that established companies have a greater focus on risk management procedures and compliance processes than start-ups because they have a greater distribution of shareholders to whom they are accountable. Accordingly, this indicates that the process of raising capital from public shareholders introduces stringent regulations and compliance issues for the company and its board.

10 Board composition

10.1 Factors influencing the selection of non-executive board members

The selection of directors is, in effect, a control mechanism to determine the composition of the board. An analysis of the selection criteria used by start-ups and established companies shows a distinct difference in focus. Table 9 compares the two sets of data which were measured on a 5-point scale where 1 = a 'major influence' and 5 = 'no influence'.

Table 9 Selection of non-executive board members

Factors influencing selection of board members	*Start-up*	*Established*
Well regarded in their industry	less	more
Well respected in business community	less	more
Recommended by the bank	less	more
Expertise in area of interest to company	more	less
Ability to introduce to key contacts	more	less
Assist with networking	more	less
Understand business risks	more	less
Recognised strategic capabilities	more	less
Provider of capital to business	more	less
Ability to represent shareholders	same (influential)	same (influential)
Expertise in the industry	same (influential)	same (influential)
Private sector board experience	same (influential)	same (influential)

From the comparisons in Table 9 established companies see new directors as bringing industry knowledge as well as their reputation in business and industry to the company. They are concerned with criteria that evaluate the candidate's reputation in their industry, business community and financial sector. Most of the factors that influence established companies in the selection of non-executive directors are external to the organisation and are consistent with the role of the board in this type of organisation as being primarily associated with accountability and oversight. Their approach could be summarised as 'what the candidate *brings to* the company'.

The criteria used by start-ups, on the other hand, could be encapsulated as 'what the candidate *can do for* the start-up'. The data showed that for start-ups the ability of a director to bring contacts, networks and capital to the business is paramount. The importance of other criteria such as strategic capability, expertise in areas of interest to the business and understanding the business's risks are also indicative of the desire to use the director as a resource for the firm. Noticeably, these factors are more focused on how directors can have a direct impact on the business. This finding is consistent with the focus of start-ups in Tables 4 to 7 and with the framework depicted in Figure 1, which describes the active role of a board in the governance of a start-up.

The results of this study have shown that there are significant differences between the governance of start-ups and established companies in New Zealand, with regard to the board's role and involvement in strategy, its level of influence and control over various

factors relating to organisational performance and the composition of the board. For start-ups a model consistent with that of active ownership (see Figure 1) described by Taylor (2003) and Bell and Mason (1995) emerged from the study with regard to director selection and fit for purpose, the role of the board in strategy and its influence on key aspects of organisational performance. When the comparative data were considered further across strategy- and performance-related elements of the survey, differences in orientation between the two types of boards highlighted the distinctive features of each.

In conjunction with the focus of discussion in board meetings, start-ups have a higher future orientation than established companies in relation to the development of the organisation and have a greater focus on competitive positioning. They place more importance on the task of monitoring the strategic health of the organisation than established companies and when selecting a new board member, start-ups assign greater importance to candidates' recognised strategic capabilities. Established companies, however, believe they have a greater influence than start-ups over the fundamental strategic direction of their organisation, their risk exposure and management of risk.

With regard to governance procedures and monitoring management activities, key differences in the characteristics of each type of organisation are also highlighted. Established companies spend more time than start-ups on routine board papers in board meetings, while start-ups tend to spend more time discussing operational and management issues. The boards of established companies believe that they have more influence over setting management incentives and media perceptions of the company than do start-ups, but the boards of start-ups perceive that they have more influence on setting directors' remuneration. With the tasks of communicating with brokers, conversing with shareholders and stakeholders and acting as ambassadors for the company, established companies spend more time and place greater importance on all these matters. This reflects the mature level of their governance and their need to manage a distributed shareholder base.

Start-up boards exhibit a focus of directors on managerial and operational matters because they use directors as a resource pool in the business and will involve them in operational decision making. This level of engagement is because the directors will generally also be shareholders and directly involved in the decision making. Established companies will generally have to take a decision to an annual meeting of shareholders, who have a vote on the matter.

From this characterisation the boards of each type of organisation can thus be differentiated on the active ownership. Established companies seek to influence and control risk management and compliance processes more than start-ups. They also focus on governance procedures and management oversight more than start-ups. This is not to say that start-ups are not concerned with these matters; rather, that they are less concerned with these issues than are established companies. This can be attributed to their relative stages in their development life cycle and the associated extent of their accountability. Start-ups are focused on attracting capital and getting their products or services to the market in order to generate cash flow. With a wider accountability, established companies are more concerned with ensuring compliance with regulatory requirements and monitoring management performance using established governance protocols.

11 Conclusion

Effective governance is based on the needs of the organisation according to the current demands, *i.e.*, they are contextual, depending upon where the organisation is in its life cycle. For this reason, the governance of start-ups and established companies is different, as has been highlighted in this study.

Established companies are large companies with a distributed shareholding. The board has a majority of non-executive directors who tend not to be shareholders in the business. Drawing capital from a wider shareholder base means that they are bound by more regulations than start-ups. This context results in a governance process that is more focused on accountability, compliance, risk management and market reporting, with a clear separation between board and management activities. Boards of established companies appear to be concerned with the governance process, in particular monitoring management, as well as with the performance of the company. They are also concerned with ensuring that the risk profile of the company is acceptable and that risk mitigation strategies are in place. Boards of established companies want to ensure compliance with relevant regulations and reporting requirements, in particular those affecting the market. They also want to ensure that effective relationships are maintained with shareholders and stakeholders in order to protect and manage their reputation assets.

Start-ups are small businesses with a concentration of ownership. As highlighted in Figure 1, the board comprises mostly executive directors who are shareholders in the business. Acting as a resource pool for the business, these directors develop and implement the strategy and are critical to the survival of the business through a high-risk phase of its development. They are also involved in the operational decision making of the business, particularly R&D, marketing channels, and capital-raising. They have less focus on formal risk management processes and compliance matters. Reporting requirements and regulatory demands are reduced due to the ownership concentration.

11.1 Application of theoretical models to this study

The results of this study highlight the difficulty of establishing a universal model for governance. The nature of governance for established companies is reasonably well aligned to agency theory. There is a clear separation between management and ownership of the company. The board places importance on monitoring, compliance and risk management of shareholders' funds. The board's primary objective is to represent shareholders' interests, and management is guided towards this objective.

The governance of a start-up organisation is more closely aligned to stewardship theory and to resource dependence theory in particular. The directors are the major shareholders in a start-up and so can be trusted to maximise shareholder returns as 'stewards' of the business: it is their money which is invested. A start-up is also dependent on the resources and skills of the directors. As indicated in this study, directors are the link to key resources for the business, and are used extensively in its operation and management. They are appointed for this reason and for their ability to use their networks to expand the company's contacts in the market.

It can thus be seen that different theories apply to the two models of governance in this study. The governance demands and theoretical constructs for start-ups can be shown to be different from those of established companies, at least in the New Zealand context. This lends support to the idea that boards need to be structured according to the strategic

requirements of the organisation which will reflect not only the external influences on their operating circumstances, but also their life cycle stage. For start-ups this is most important if the Icarus Paradox, that is, the tendency to 'crash and burn' (Kwak, 2002), is to be resolved. CEO-entrepreneurs who understand the value of a strong and effective board with the requisite characteristics for meeting the particular challenges of their life cycle will be better placed to utilise their board's strength in ensuring the company evolves into a stable, high-performing enterprise.

This study has provided insight into the nature of governance in start-up companies and has indicated a model of active ownership as being an appropriate framework for structuring an effective board for this type of organisation. To further develop the model, research could be directed at identifying the optimum corporate governance processes and practices for a start-up organisation. This could be seen as a minimum set of requirements that would foster innovation and agility and at the same time ensure that the appropriate requirements of governance were in place. Determining whether independence of governance in start-ups is an issue would also be useful, given the high level of involvement of executive directors and the low level of involvement of independent directors. In addition, conducting qualitative research with experienced directors of start-ups would be of value in learning how more effective governance of these enterprises could enhance their chances of survival and getting their product or services to market.

References

Becht, M., Bolton, P. and Roell, A. (2002) 'Corporate governance and control', Working paper No. 02, European Corporate Governance Institute.

Beekes, W., Pope, P. and Young, S. (2004) 'The link between earnings, timeliness, earnings conservatism and board composition: evidence from the UK', *International Conference on Corporate Governance*, Birmingham, UK.

Bell, G. and Mason, H. (1995) 'The Bell-Mason framework', http://www.bellmasongroup.com/framework.htm (retrieved 20 October 2005).

Berle, A.A. and Means, G.C. (1932) *The Modern Corporation and Private Property*, New York, NY: Macmillan Publishing Co.

Bhide, A. (2000) 'Closing keynote address: TiE annual conference', May, http://www.bhide.net/book/Bhide_tiecon_keynote.PDF (retrieved 22 October 2005).

Bohren, O. and Odegaard, B.A. (2003) *Governance and Performance Revisited*, JEL Codes G3 L22, ECGI – Finance Working Paper No. 28/2003, EFA 2003 Annual Conference Paper No. 252.

Carter, C.B. and Lorsch, J.W. (2004) *Back to the Drawing Board: Designing Corporate Boards for a Complex World*, Boston, MA: Harvard Business School Press.

Carter, D.A., Simkins, B.J. and Simpson, W.G. (2003) 'Corporate governance, board diversity, and firm value', *The Financial Review*, February, Vol. 38, p.33.

Case, J. (2001) 'The Gazelle theory', *INC Magazine*, May, http://www.inc.com/magazine/20010515/22613.html (retrieved 20 October 2005).

Daily, C.M. and Dalton, D.R. (1993) 'Board of directors leadership and structure: control and performance implications', *Entrepreneurship Theory and Practice*, Spring, Vol. 17, No. 3, pp.65–81.

Dawson, S. (2004) 'Balancing self-interest and altruism: corporate governance alone is not enough', *Corporate Governance: An International Review*, April, Vol. 12, No. 2, pp.130–133.

Deakins, D., O'Neill, E. and Mileham, P. (2000a) 'Insiders vs outsiders: directors' relationships in small, entrepreneurial companies', *Enterprise & Innovation Management Studies*, 1 May, Vol. 1, No. 2, pp.175–186.

Deakins, D., O'Neill, E. and Mileham, P. (2000b) 'The role and influence of external directors in small entrepreneurial companies: some evidence on VC and non-VC external directors', *Venture Capital*, April, Vol. 2, No. 2, pp.111–127.

Denis, D.K. and McConnell, J.J. (2003) 'International corporate governance', *European Corporate Governance Institute*, Working Paper No. 05.

Forbes, D.P. and Milliken, F.J. (1999) 'Cognition and corporate governance: understanding boards of directors as strategic decision-making groups', *Academy of Management Review*, July, Vol. 24, No. 3, pp.489–505.

Fox, M. (1995) 'Studies of corporate governance in New Zealand', Unpublished thesis (PhD), University of Canterbury, New Zealand.

Gabrielson, J. and Huse, M. (2002) 'The venture capitalist and the board of directors in SMEs: role and process', *Venture Capital*, Vol. 4, No. 2, pp.125–146.

Higgs, D. (2003) *Review of the Role and Effectiveness of Non-executive Directors*, The Department of Trade and Industry, The Stationery Office, London.

Ingley, C. (2004) 'From conformance to performance: the strategic role of the board and its involvement in corporate leadership', Unpublished doctoral thesis, RMIT University, Melbourne, Australia, June.

Ingley, C. and van der Walt, N. (2005) 'Do board processes influence director and board performance? Statutory and performance implications', *Corporate Governance: An International Review*, Vol. 13, No. 5, pp.632–653.

Ingley, C.B. and van der Walt, N.T. (2003) 'Board configuration: building better boards', *Corporate Governance: The International Journal of Effective Board Performance*, Vol. 3, No. 4, pp.5–17.

Kaplan, S.N. and Minton, B.A. (1994) 'Appointments of outsiders to Japanese Boards: determinants and implications for managers', *Journal of Financial Economics*, October, Vol. 36, No. 2, pp.225–258.

Keil, G.C. and Nicholson, G.J. (2003) 'Board composition and corporate performance: how the Australian experience informs contrasting theories of corporate governance', *Corporate Governance: An International Review*, Vol. 11, No. 3, pp.189–205.

Kwak, M. (2002) 'The perils of power', *MIT Sloan Management Review*, Spring, Vol. 43, No. 3, p.13.

Larson, P.N. (2000) 'Lessons from old and new economy boards', *Directorship*, December, Vol. 26, No. 11, pp.1–3.

Lorsch, J., Zelleeke, A.S. and Pick, K. (2001) 'Unbalanced boards', *Harvard Business Review*, February, Vol. 79, No. 2, pp.28–29.

Mair, J. (2000) 'Optimal executive holdings and board size: links with firm performance in New Zealand', *Research Report*, Massey University, Palmerston North, New Zealand.

McCaffrey, K. (2005) 'Effective governance for start-up companies in New Zealand', *Research Report (MMgt)*, Albany, New Zealand: Massey University.

Monks, R.A.G. and Minow, N. (2003) 'Ownership-based governance: corporate governance for the new millennium', *Social Science Research Network*, http://papers.ssrn.com/sol3/papers.cfm ?abstract_id=6148 (retrieved 22 October 2005).

Nesheim, J. (2000) *The Complete How-to Handbook for Creating Successful New High-tech Companies*, New York, NY: Free Press.

Smith, S. (2003) *Corporate Finance Partner, PricewaterhouseCoopers, Personal Communication with the Researchers*.

Strenger, C. (2004) 'The corporate governance scorecard: a tool for the implementation of corporate governance', *Corporate Governance*, January, Vol. 12, No. 1, pp.11–15.

Tan, A. (2001) 'Ownership structure, investment and corporate value: New Zealand evidence', *Research Report (MBS)*, Massey University, Albany, New Zealand.

Taylor, B. (2003) 'Board leadership: balancing entrepreneurship and strategy with accountability and control', *Corporate Governance: An International Review*, Vol. 3, No. 2, pp.3–5.

Van den Berghe, L.A.A. and Levrau, A. (2004) 'Evaluating boards of directors: what constitutes a good corporate board?', *Corporate Governance: An International Review*, October, Vol. 12, No. 4, pp.461–478.

Westphal, J.D. (2002) 'Second thoughts on board independence: why do so many demand board independence when it does so little good?', *The Corporate Board*, September–October, Vol. 23, No. 136, pp.6–10.

Wier, C., Laing, D. and McKnight, P. (2003) 'An empirical analysis of the impact of corporate governance mechanisms on the performance of UK firms', Aberdeen Business School, The Robert Gordon University, Aberdeen http://papers.ssrn.com/sol3/papers.cfm?abstract_id=286440 (retrieved 22 October 2005).

Wymeersch, E. (1998) 'Comparative corporate governance: a status report on corporate governance', *Rules and Practices in Some Continental European States*, Oxford, UK: Clarendon Press.